2005

Not-for-profit organizations industry developments - 2005; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Not-for-Profit Organizations Industry Developments — 2005

Strengthening Audit Integrity
Safeguarding Financial Reporting

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of not-for-profit organizations with an overview of recent economic, technical, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Accounting and Auditing Publications

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Not-for-Profit Organizations Industry Developments—2005

How This Alert Helps You

This Audit Risk Alert helps you plan and perform your not-for-profit organization audits. The information delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

If you understand what is happening in the not-for-profit industry, and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry information and understanding it.

Understanding the Organization and Its Environment and Assessing Risks

An auditor should obtain an understanding of relevant industry, regulatory, and other external factors. These factors include the following:

- Industry conditions
- The regulatory environment encompassing, among other matters, relevant accounting pronouncements
- The legal and political environment
- Other external factors, such as general economic conditions

The not-for-profit industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive).

The auditor should obtain an understanding of the organization's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the organization's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. An understanding of business risks increases the likelihood of identifying risks of material misstatement, although the auditor does not have a responsibility to identify or assess all business risks. Many business risks could eventually have financial consequences and, therefore, affect the financial statements; however, obviously not all business risks give rise to risks of material misstatement.

After gaining an understanding of the organization and its environment, the auditor needs to make risk assessments at the financial statement and relevant assertion levels based on that understanding.

Presented in this Alert are current business, economic, regulatory, accounting, and auditing matters that may affect your clients. Reading about these matters and properly addressing them as necessary will help you gain a better understanding of your client's environment, will help you better assess risks of material misstatement of the financial statements, and will ultimately strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

In planning their audits, auditors need to understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and the labor market are likely to have an impact on the organization's financial statements being audited.

As of the first quarter of 2005, the U.S. economy grew at an annualized real rate of 3.1 percent, the lowest growth in eight quarters. According to the Commerce Department, the deceleration from the previous quarter's 3.8 percent rate was attributable to sluggish personal consumption, higher imports, and slower capital investment. Additional signs the economy is slowing down are elevated energy prices and interest rates, an underperforming stock market, deteriorating consumer confidence, and wage levels that have failed to keep up with the cost of living. The Department of Labor (DOL) reported that consumer prices rose in March 2005 at the fastest rate since October of 2004, outpacing gains in most workers' wages, as households paid more for energy, clothing, hotel rooms, medical care, and other items. As a result, personal consumption, which accounts for two-thirds of the nation's economy, rose 3.5 percent in the first quarter of 2005, falling from a 4.2 percent rise in the previous quarter.

Although inflation remains low, continuing concerns about inflation are depressing financial markets. The Dow Jones industrial average fell 115.05 points, or 1.1 percent, to close at 10,012.36 in April 2005, its lowest close since October.

The Bureau of Labor Statistics (BLS) reported that employment increased by 274,000 in April 2005, while the unemployment rate remained at 5.2 percent.

Concerned about inflation, the Federal Reserve continued to raise interest rates by one-quarter percentage point, to 3 percent, which marked the eighth rate increase of that size since last June. "Core" inflation had climbed in March by 0.4 percent, its highest reading in 2½ years. However, a government report showed that core inflation was flat in April.

The State of Not-for-Profits

Individuals, corporations, and foundations gave a total of $248.5 billion in 2004, a 2.3 percent rise from 2003 levels, according to the *Giving USA* 2005 report. Giving percentages have reached their highest growth since 2000. Currently, many not-for-profits are reporting a boost in donations. In the annual *Giving USA* survey, 55 percent of responding organizations reported increases in charitable gifts received in 2004 compared with 2003. However, the demand for their services has also shot up, according to an economic survey conducted by GuideStar.

Not-for-profits face challenges from the current economic environment and an increasingly competitive marketplace. Nearly 800,000 charities are registered in the Internal Revenue Service's (IRS's) business master file, practically twice as many as in 1990. Small organizations, with revenue of $25,000 or less, account for most of the growth in the number of charities. The total number of charities grew by 5.6 percent in 2003, outpacing the creation of other kinds of tax-exempt groups. Vigorous competition for government aid and private donations exists as a result of the proliferation of not-for-profits.

In conjunction with the surge of not-for-profits and recent perceived abuses at several charitable groups, regulators are cracking down on not-for-profits. For instance, new laws are being contemplated regarding IRS reexamination of charities' tax-exempt status.

The IRS is conducting a compensation study and reviewing executive salaries and perks that appear excessive. Currently, the median not-for-profit salary of 215 chief executives surveyed in 2003 was $291,356, according to a recent study by the *Chronicle of Philanthropy*. The Senate Finance Committee is examining proposals regarding federal requirements for audits, requirements for auditor rotation, periodic review of tax-exempt status, increasing penalties for incomplete Form 990, Return of Organization Exempt From Income Tax, and requirements for enhanced disclosure of compensation of board members, among other matters.

The states are looking at governance legislation as well. California is one of the first states to pass such legislation requiring, among other provisions, charities to have audit committees as well as independent audits over a threshold level. This legislation affects California charities as well as not-for-profits from other states doing business and/or soliciting contributions in California.

Similar bills are being considered by 16 other states. There are also pressures from Congress and its Joint Committee on Taxation. That committee released a proposal in April 2005 to limit noncash deductions to $500, no matter how much is donated. Not-for-profits fear such a limitation may inhibit charitable giving by taking away the tax incentive. Similarly, not-for-profits predict that the new tax laws regarding vehicle donations, which now limit the taxpayer's deduction to the amount the charity receives when it sells the vehicle, will also inhibit charitable giving. Goodwill Industries has already seen a 60 percent drop in vehicle donations compared to last year.

Congress has reintroduced another piece of legislation, the Charity Aid, Recovery and Empowerment Act (CARE Act), which would allow nonitemizers to deduct contributions and receive the same benefits as itemizers. Proponents believe that this legislation could funnel billions of dollars into charities. Nonitemizers currently donate approximately $36 billion to charity. The new legislation could lead to an increase in donations by 26.7 percent, according to a new report. See more detailed discussions in the "Regulatory and Legislative Developments" section later in this Alert.

Another tax issue that may affect charities is the potential estate tax cut. According to a study conducted by the Brookings Institution and Urban Institute, if the federal estate tax is repealed permanently, the impact on charities may be a decline in giving of roughly $10 billion a year. Although charities depend on the tax code to establish incentives for giving, they also count on the generosity of the wealthy who would benefit from the potential estate tax cut. So in an effort to not bite the hand that feeds them, most charities are staying silent on this issue. According to Congress's Joint Committee on Taxation, federal tax revenue would diminish by approximately $29 billion a year as a result of the potential estate tax cut. The loss of this revenue has the potential to cut federal funding for charitable programs.

Individual Giving

Gifts by living individuals continue to be a great philanthropic resource, as their contributions rose by an estimated 4.1 percent in 2004 to reach $187.92 billion, 75.6 percent of all contributed dollars in 2004. Bequests by deceased individuals rose by 6.4 percent in 2004 to $19.8 billion, 8.0 percent of all contributed dollars in 2004, according to the *Giving USA* 2005 report.

Corporate Philanthropy

Corporations also increased their giving by 4.5 percent in 2004, amounting to $12.0 billion, which represents 4.8 percent of all cash contributions in 2004, according to the *Giving USA* 2005 report. According to the Contribution Academy, which keeps tabs on corporate philanthropy, U.S. corporations are projected to donate $750 million in cash and in-kind gifts in response to the Tsunami relief efforts. For example, Merck is giving $10 million and Pfizer is giving $35 million in cash and in-kind contributions, such as medicines. This type of cause marketing affords corporations an opportunity to use their corporate brand and image for a worthy cause. According to a 2004 survey by Boston consultant Cone Inc., 91 percent of those surveyed responded that they have a more positive image of corporations that support a cause. As employee, investor, and societal expectations grow regarding corporate responsibility toward economic and social roles, corporate aid is developing into a standard component of the annual budgets of the majority of multinational corporations.

Foundation Philanthropy

Gifts to foundations in the United States grew by 8 percent, attaining 11.6 percent of all contributed dollars, reaching $28.8 billion in 2004, according to the *Giving USA* 2005 report. The continued interest in foundation philanthropy by wealthy Americans is attributable to higher levels of new gifts in existing foundations in 2003, a recovering stock market, and the formation of new foundations.

Donor-Advised Funds

Donor-advised funds, also known as charitable gift funds and charitable gift trusts, have been rapidly on the rise for the second straight year in 2004, according to the *Chronicle's* sixth annual survey of gift funds. Quite simply, making a contribution to a donor-advised fund, whether it is cash, stock, or other assets, allows donors to set up charitable accounts, claim a tax deduction, and recommend (but not command) how and when the money will be distributed to various charitable organizations selected.

As the interest in donor-advised funds became apparent with a rise in assets between 2003 and 2004, Congress considers new rules that may hinder the attractiveness of these funds. Recently, these funds have been under fire because, unlike private foundations that are required to distribute at least 5 percent of their assets every year to charities, donor-advised funds have no minimum payout requirement. However, the *Chronicle*'s survey ascertained that donor-advised funds distributed a median of 15.8 percent of their assets last year to charities. There are allegations that some of these donor-advised funds are not being used entirely for charitable purposes.

Noncash Donations to Donor-Advised Funds

Lawmakers are also proposing limits to the types of contributions people can make to donor-advised funds or any other type of charitable organization because of concerns that donors are deducting significantly more on their taxes than the donations are worth. The types of contributions in question are land, land rights, artwork, real estate, and other noncash assets.

Tsunami Disaster

The Southeast Asia tsunami in December 2004, the most horrific natural disaster the modern world has ever witnessed, is well on its way to developing into one of the biggest, most costly relief efforts recorded. American charities have raised more than $597 million for relief, a great deal of that on the Internet.

Internet Fund-Raising

The Internet is turning out to be progressively more important for raising awareness about a charity's mission, communicating with supporters, supplying new donors, compelling government to give more, and stimulating donations. For example, the Internet facilitated the charitable sector's quick and effective response to the tsunami relief effort with Web contributions exceeding

$350 million in the first two weeks after the disaster. This highlights the record amounts of monies that can be raised online in a matter of days by small organizations. The Internet affords charities the ability to maximize outreach to constituents by launching e-mail appeals in the event a crisis strikes and needs arise.

It is estimated that organizations will raise an average of 5 percent to 10 percent of their funds online and around 40 percent to 50 percent for event-related fund-raising online in 2005.

Online communication with current and potential donors is even more appealing due to the changing economics of direct mail. The Internet can be used to post newsletters, e-mail messages to donors, and provide information for potential donors. Through the Internet, organizations can nurture relationships with online donors by keeping them apprised of progress including identifying goals, setting schedules, and tracking results on a regular basis.

Auditors should refer to the relevant auditing literature, including Statement on Auditing Standards (SAS) No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326), if their not-for-profit clients engage in online philanthropy as a major source of funding and Statement of Position (SOP) 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, if the not-for-profits engage in joint activities.

Charity and Fraudulent Scams

Auditors may want to take note of the fact that in this current environment, donors are being reminded to be vigilant and well informed in their giving to charities. Some illegitimate not-for-profits have taken advantage of the recent tsunami relief efforts, resulting in negative publicity for not-for-profits in general. Although many charities are household names, the Internet has made it possible for illegitimate charities to emerge.

Unfortunately, the Internet and the abundance of charity-related spam e-mails allow for shady operators to profit from tragedies, such as the tsunami disaster, by setting up makeshift charities, misappropriating the money, and then vanishing. Not-for-profits should be plugged in to the fact that many givers are becoming more savvy and performing their own independent check on a charity by going to GuideStar.org or other watchdog charities.

CAN-SPAM

Another environmental factor that may result in negative publicity for not-for-profits is CAN-SPAM. The Federal Trade Commission (FTC) has issued the Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (CAN-SPAM Act), which establishes requirements for those who send "commercial" e-mail, spells out penalties for spammers and companies whose products are advertised in spam if they violate the law, and gives consumers the right to ask e-mailers to stop spamming them.

Not-for-profit organizations are not exempt from the CAN-SPAM rules, unlike their exemption from the FTC's Do Not Call Registry. However, for most not-for-profits, the rules are straightforward. Organizations that regularly send e-mails of a commercial nature should check to ensure that they are not in violation of the rules.

When the FTC adopted these rule provisions on December 16, 2004, it determined that they would become effective on February 18, 2005. However, the Office of Management and Budget's (OMB's) Office of Information and Regulatory Affairs has determined that the provisions constitute a "major rule" under the Small Business Regulatory Enforcement Fairness Act, and as such the provision cannot take effect until at least 60 days after publication in the *Federal Register*. The revised effective date was March 28, 2005. The FTC's final rules can be downloaded at www.ftc.gov/os/2005/01/050112canspamfrn.pdf.

Readers may also refer to an article by GuideStar summarizing the steps an organization should follow to ensure that its e-mail is compliant with the Act's requirements at www.guidestar.org/news/features/can_e_mail.jsp.

Donor Privacy

Donor privacy is yet another environmental factor that may result in negative publicity for not-for-profits. Whether a donor is contacted via telephone, in person, by mail, from a special event, or over the Internet, privacy is a concern. Privacy is a very costly control for most not-for-profits, especially with the growing pervasiveness of the Internet. As Internet fund-raising has grown immensely over the past five years and with great success, so has the potential for fraudulent schemes, including identity theft. Some donors are troubled about the security of donating to charities online. Not-for-profits need to consider the need to download and secure donor information in a timely and efficient manner. Currently many not-for-profits are attaching privacy statements to their Web sites and using opt-in, opt-out programs. Direct mail appeals are targets for identity theft as well, due to the personal information included. Like the Internet, privacy statements are included in the mailing along with opt-out information. Not-for-profits should make donors aware of how their personal information will be used and if it will be rented or given to another organization.

Volunteer Value

Approximately 6 in 10 adults in the United States volunteered their time to a not-for-profit in 2004. Not-for-profits depend on volunteers for vital activities, such as increasing the quality of services or programs provided, so they need to manage that resource effectively. Volunteerism also generates substantial cost savings. Fund-raising, selling items for charity, tutoring, coaching, being an usher or a greeter, and collecting or distributing food are all activities in which volunteers donate their time. As per the Independent Sector, the value of donated time rose to $17.55 per hour, an increase from the 2003 rate of $17.19. Last year, Americans donated approximately $22 billion in service hours, according to the Independent Sector.

In some cases, the value of time must be reflected in an organization's financial statements. Not-for-profit organizations should comply with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made,* for accounting for contributed services to determine whether the value may be recorded in its financial statements. Also see paragraphs 5.52 and 5.53 of the AICPA Audit and Accounting Guide *Not-*

for-Profit Organizations (NPO Guide) for further guidance. The value of volunteer services may be presented in financial statements, including statements for internal and external purposes, grant proposals, and annual reports, only if a volunteer is performing a specialized skill for a not-for-profit. The general rule to follow when determining if contributed services meet FASB Statement No. 116 criteria for inclusion in the financial statements is to determine whether the organization would have purchased the services had they not been donated.

Gifts-in-Kind Philanthropy

Over the past few years, gifts-in-kind as a percentage of corporate contributions have increased. Most corporations already encompass cash donations and volunteer hours in their philanthropic outreach but now are expanding their giving through gifts-in-kind. Gifts-in-kind may include company products (the fastest growing type of gifts-in-kind), property, equipment, construction services, and other material donations. In recent years, noncash contributions, also known as product donations or gifts-in-kind, have grown tremendously as a percentage of corporate contributions. See the discussion in the section titled "Auditing Gifts-in-Kind" and "Accounting for PPE and Inventory Received as Gifts-in-Kind" later in this Alert.

Lawmakers and Regulators Still Target Not-for-Profits for Close Observation

Given that not-for-profits operate by using contributions received from the public as well as government grants and that tax deductions are allowed for charitable contributions, a public interest in how the money is used exists. Federal and state regulators continue to focus on transparency and financial management, governance and self-regulation, and oversight and enforcement of the sector. Various states have been active in proposing legislation to further regulate the not-for-profit sector. Readers should refer to the "Sarbanes-Oxley Act and Not-for-Profits" and the "Legislative Activities Aimed at Strengthening Governance and Accountability Turn Into New Legal Requirements" sections of this Alert for further developments on this matter.

Taxation of Internet Access and Sales

On December 3, 2004, President Bush signed into law a three-year Internet access tax moratorium (S-150) (Public Law [PL] 108-435), which extends the ban on Internet taxes that expired on November 1, 2003, the original version of the Internet Tax Nondiscrimination Act (Public Law [PL] 107-075). The original Act banned new Internet access taxes and new, multiple, and discriminatory taxes on electronic commerce (Internet sales). Bills introduced in Congress in 2004 separated the issue of taxes on Internet access from the issue of taxes on Internet sales.

A compromised version of S-150 allows states and cities to continue to collect taxes on telephone services, even if the calls are made over the Internet. It also allows states already collecting taxes on Internet access to continue doing so for up to four years. The final legislation additionally broadens the scope of the ban by expanding the definition of "Internet access" to include telecommunications services. The Internet tax moratorium is set to expire November 2007, at which time Congress will revisit the issue. In the interim, this final legislation is projected to prevent local governments from collecting an estimated $500 million in business taxes on Internet services.

A group of states is aggressively supporting the passage of the Streamlined Sales and Use Tax Act, which may become a reality in 2005. Currently, 18 states require the collection of sales tax on items purchased over the Internet and 22 more are in the process of enacting such requirements. However, many consumers are unaware that they are required to pay such taxes. The proposed legislation will provide uniform sales tax procedures and enable states to enforce the collection of sales taxes. Consumer purchases carried out on the Internet will eventually be taxed the same as any other purchases made by the consumer. Meanwhile, more retailers are joining the ranks of those voluntarily collecting taxes on Internet sales, and several states have added lines on their income tax forms seeking to recover some of the estimated $9 billion lost nationally each year on uncollected sales taxes from Internet and mail order purchases.

Regulatory and Legislative Developments

Auditors of not-for-profits may need to monitor changes in government regulations for various reasons. For example, they may be required to comply with *Government Auditing Standards* (GAS), also referred to as the Yellow Book.[1] In addition, auditors may be required to perform a single audit and comply with applicable rules. A *single audit* is an audit of an entity's federal financial assistance, as required by the Single Audit Act Amendments of 1996 (the Act), and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133).[2] Not-for-profits may also be affected by other federal, state, and local laws, such as laws regulating the registration of not-for-profits and tax laws.

In the past, the not-for-profit Audit Risk Alert has discussed developments related to the following regulatory matters:

- Circular A-133 Audit Guidance Update
- Annual Compliance Supplement—Issued to help you understand the objectives, procedures, and compliance requirements of approximately 160 federal programs:
  - Data Collection Form Revision and Electronic Submissions
  - Federal Grant Streamlining Program
  - Orange Book
  - Circular A-133 Audit Reviews
- *Government Auditing Standards*

Discussions of those developments now appear in the AICPA Audit Risk Alert *Single Audits—2005*.

1. Although *government auditing standards* primarily apply to federal assistance, some states have adopted government auditing standards.

2. Instead of a single audit, under certain circumstances, program-specific audits may be conducted.

Internal Revenue Service Activities

IRS's Plans for Heightened Enforcement

The IRS plans on focusing on four crucial initiatives:

1. Credit counseling
2. Antiterrorism efforts
3. Excessive compensation
4. Abusive schemes

The IRS will be coordinating its efforts with the states for a more effective exchange of information on abusive schemes. Furthermore, the IRS has hired 75 new agents and formed new examination units designed to hinder abusive practices in the following not-for-profit areas: credit counseling organizations, donor-advised funds, exempt supporting organizations, and low-income housing organizations.

Charities and Foreign Activities

The IRS is in the process of auditing roughly 100 tax-exempt organizations that make foreign grants as a result of the rising consternation that U.S. charities are involved in the financing of activities of international terrorists, whether knowingly or inadvertently. The revised Form 1023, Application for Recognition of Exemption, will raise awareness and promote the charities' ability to monitor more closely how the aid is being used in other countries by asking for more detailed information. New charitable organizations that plan to have foreign operations will be required to provide certain details regarding such operations as part of the revised exemption application. The nature of the applicant's foreign activities will determine the type of specific information that will be required as part of the exemption application. For example, if the charity has or will have direct operations in a foreign country, the exemption application requires the charity to divulge each country and the regions of operation within each country. Furthermore, the activities by country and by region must be described, as well as how the operations in each foster the applicant's exempt purpose. Another example is if the charity makes or will make grants, loans, or other distributions, such as the distribution of goods to a foreign organization, then the exemption application requires the charity to provide the name of each foreign recipient, name the country and regions within the country in which the recipient operates, and describe any relationship between the applicant and the recipient. If a charity receives contributions designated for specified foreign recipients, such as countries and/or organizations, those countries and/or organizations must be identified. Existing exempt organizations will be required to provide such information upon IRS request if they come under examination.

Form 1023 also recommends that U.S. charities should have a reasonable understanding of what the foreign grantees are using their resources for. A reasonable understanding can be obtained through pregrant inquires of the recipient organization and compliance checks by impartial experts or site visits by personnel of the U.S. charity to verify that grant funds are appropriately being used. By taking these steps, the U.S. charity will be able to plead its case with the IRS that the organization has made reasonable efforts to monitor the use of its funds.

IR-2004-106—Tax Exempt Compensation Enforcement Project

The IRS began the Tax Exempt Compensation Enforcement Project at the end of July 2004 and will continue into 2005 reviewing the compensation practices of almost 2,000 not-for-profit organizations. The project's objective is to identify and stop the progress of abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers and other insiders. Some of the IRS contacts will simply be through correspondence, while others will involve examinations. The IRS notes that a contact does not necessarily imply improper activity by the organization.

The initiative will focus on compensation of officers, transactions (such as loans and leases) with officers, and excess benefit transactions reported on Form 990. Since one of the initiatives will focus on other insider transactions, such as loans and sales of property between insiders and the organizations, organizations must be familiar with who their insiders are and appropriately document any transactions with them.

For additional guidance the IRS issued a series of Technical Advice Memoranda (TAM) on the subject of automatic excess benefit transactions that take place when an organization pays personal expenses for insiders and does not comply with the tax regulations to appropriately document payments as compensation.

Charity Scams Included in the IRS's Dirty Dozen

The IRS's "dirty dozen" for 2005 includes several new scams that manipulate laws governing charitable groups. Readers should be aware of the following three arrangements involving charities and not-for-profit organizations that are high on the 2005 IRS dirty dozen tax scam list: credit counseling agencies (number 4 on the tax scam list), corporation sole (number 7 on the tax scam list), and abuse of charitable organizations and deductions (number 9 on the tax scam list).

Credit Counseling Agencies. The IRS Tax Exempt and Government Entities Division has made auditing credit counseling organizations a priority because some of these tax-exempt organizations, which are intended to provide education to low-income customers with debt problems, are charging debtors large fees while providing little or no counseling.

Corporation Sole. Since September 2004, the Department of Justice has obtained six injunctions against promoters of this scheme and filed complaints against 11 others. Participants apply for incorporation under the pretext of being a "bishop" or "overseer" of a one-person, phony religious organization or society with the idea that this entitles the individual to an exemption from federal income taxes as a not-for-profit, religious organization. When used as intended, corporation sole statutes enable religious leaders to separate themselves legally from the control and ownership of church assets. Abusive promoters, however, have conducted seminars for which taxpayers are charged fees of $1,000 or more and where attendees are incorrectly told that corporation sole laws provide a “legal” way to escape paying federal income taxes, child support, and other personal debts.

Abuse of Charitable Organizations and Deductions. The IRS has observed an increase in the use of tax-exempt organizations to improperly shield income or assets from taxation. This can occur, for example, when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund but maintains control over the assets or income, thereby obtaining a tax deduction without transferring a commensurate benefit to charity. Contributions of in-kind goods with overinflated values is another example.

Conservation Easements

According to the IRS Commissioner Mark Everson, the IRS is currently auditing 50 donors of conservation easements and several exempt organizations that receive such easements. It is doing a “preaudit review” of 400 open-space easement donations, “to be followed by a similar review of 700 facade easements.”

Donation of easements on the facades of houses in historic areas has grown dramatically. The homeowner donates an easement—giving up the right to alter the facade—and deducts the amount by which that has reduced the value of the house. Because of restrictions that often already apply to such property, however, “the taxpayers may, in fact, be giving up nothing, or very little,” Everson said. “A taxpayer cannot give up a right that he or she does not have.” Such easements have become a significant issue in some areas.

New E-File Requirements for Charities and Nonprofits

Form 990 is used by tax-exempt organizations, including charities, private foundations, and not-for-profit organizations, to provide disclosure of releasable data to the public as provided by law. As discussed in last year’s alert, the IRS has designed an electronic filing process for Form 990/990EZ under the IRS e-file program, which began in February 2004. The National Association of State Charity Officials (NASCO) has partnered with the IRS to ensure that state requirements are considered. Currently, 37 state and local governments currently accept Form 990/990EZ to satisfy their filing or registration requirements. The first release included Forms 990, 990EZ, 1120 POL, and 8868. In January 2005, e-file availability was extended to private foundations with release of Form 990-PF, *Return of Private Foundation.*

Answers to questions regarding e-filing for charities and nonprofits are contained in a frequently asked questions (FAQ) document that can be found at www.irs.gov/charities/article/0,,id=137531,00.html.

On January 12, 2005, the IRS released new e-file requirements for large tax-exempt organizations. The new regulations require certain tax-exempt organizations to file annual exempt organization returns electronically beginning in 2006. For tax year 2005 returns due in 2006, the regulations require organizations with total assets of $100 million or more to file electronically; however, electronic filing requirements only apply to entities that file at least 250 returns, including income tax, excise tax, employment tax, and information returns, during a calendar year. For example, if an organization has 245 employees, it must file Form 990 or Form 990-PF electronically, because each Form W-2 and quarterly Form 941 is considered a separate return; therefore, the organization files a total of 250 returns (245 W-2's, four 941's, and one 990/990-PF).

Private foundations and charitable trusts will be required to file Form 990-PF electronically beginning in 2007 regardless of their asset size, if they file at least 250 returns.

In addition, readers should monitor the IRS Web site for the following pending releases:

- State Retrieval System, available in 2006 (allowing states to access information through a shared database with the IRS)
- Form 990-T (Exempt Organization Business Income Tax Return) e-filing available in 2007

The AICPA recommended that the IRS delay, by at least a year, implementation of mandatory electronic filing (e-file) procedures for large corporations and exempt organizations at a hearing before the IRS. Although the AICPA agrees with the IRS's long-term goals for the electronic tax administration, it questions whether the lead time before required implementation is sufficient.

Final Extension Rules—Forms 990, 990PF, and 990T

The Treasury Department and IRS published final regulations on automatic extensions of time to file exempt organization returns. Treasury Decision 9163 (November 23, 2004) removes the requirement for a signature and explanation on an extension request for returns including Forms 990, 990-EZ, and 990-PF. Exempt organizations may obtain a three-month automatic extension by filing Form 8868 in accordance with its instructions. The regulations also clarify that filers of Form 990-T, the unrelated business income tax return, may obtain a six-month automatic extension by properly filing Form 8868.

October 2004 Revision of Form 1023

The IRS has revised the exemption application Form 1023, Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code (IRC), and the instructions for Form 1023. An FAQ document was developed by the IRS to explain the revisions and the transition from the prior to the new version of the form. This document can be found on the IRS Web site at www.irs.gov/eo.

Readers should be aware that after April 30, 2005, organizations *must* use the new version of the form or the IRS will return it to the organization as an incomplete application.

Updated Fee Schedule Regarding Public Inspection of Exempt Organizations Material

On January 5, 2005, the Treasury Department published final regulations providing that IRS fees for copies of exempt organizations applications and returns should be no more than the fee schedule promulgated under the Freedom of Information Act (FOIA). The final regulations were adopted without any changes to the temporary regulations published in 2003.

Exempt organizations that must furnish copies to requesters may charge copying fees that correspond to the IRS fees. Under the

IRS FOIA fee schedule, the first 100 pages copied by or for requesters, except commercial requesters, are free of charge. Effective December 19, 2002, the fees are to be established by the Commissioner from time to time. Currently, the Commissioner has established fees of (1) $.20 per page for each subsequent page of exempt organization returns and related documents, up to 8½ by 14 inches, made by photocopy or similar process, and (2) actual cost for other types of duplication.

The regulation concerns documents that must be made publicly available under IRC section 6104, which contains the exempt organization rules related to public inspection of certain annual returns, reports, and applications for exemptions.

Revising Section 403(b) Tax-Sheltered Annuity Contracts

The Treasury Department and IRS issued proposed Income Tax Regulations (REG-155608-02, 2004-49 I.R.B 924) on November 16, 2004. These proposed regulations provide updated guidance on tax-sheltered annuities, custodial accounts of public schools, IRC section (503(c)(3) tax-exempt organizations, and church retirement income accounts authorized under IRC section 403(b). These proposed regulations reflect numerous changes made to the tax laws since promulgation of the existing IRC section 403(b) regulations in 1964. These regulations will provide the public with guidance necessary to comply with the law and will affect sponsors of IRC section 403(b) contracts, administrators, participants, and beneficiaries.

Generally, when finalized, these regulations will be effective for taxable years beginning after December 31, 2005. Readers may find the proposed regulations at www.irs.gov/irb/2004-49_IRB/ar14.html.

Revenue Ruling: Trade Association's Internet Activities Excepted From Unrelated Business Tax

Revenue Ruling 2004-112, 2004-51 I.R.B., holds that under specified circumstances, Internet activities conducted by IRC section 501(c)(6) exempt trade associations fall within the specific exception for qualified convention and trade show activity under IRC section 513(d)(3)(B). To qualify for this exception, income-producing activities must meet the following requirements:

1. They must be conducted by a qualifying organization (including an IRC section 501(c)(6) organization) that conducts as one of its substantial exempt purposes a show that stimulates interest in and demand for products of an industry (or industry segment) or that educates those attending about new developments or products and services related to the organization's exempt activities.
2. The activity must be a qualifying convention or trade show activity, that is, any activity of a kind traditionally conducted at conventions, annual meetings, or trade shows.
3. The activity must be conducted in conjunction with a convention or trade show.

In one situation addressed in the ruling, the trade association operated one Web site on the premises of its trade show, and a second site during the time period when it was conducting the show. Income from both sites was within the exception.

In a second situation, a trade association operated a Web site available to the public for a two-week period not overlapping or coinciding with any trade show. Income received from those wishing to have information listed on the Web site was not within the exception.

IRS Clarifies Its Position on Funding of Not-for-Profit Lobbying

The IRS sent a letter in early 2005 to Charity Lobbying in the Public Interest, a not-for-profit that promotes and protects not-for-profit advocacy and lobbying, to clarify the IRS's position on foundation funding of not-for-profits that lobby. The letter clarifies that foundations may fund not-for-profits that lobby as a means of reaching philanthropic goals while also providing suggested language that a foundation may use in their grant letters to not-for-profits to clarify their funding requests.

Supporting Organizations

Supporting organizations function in ways similar to private foundations but without the burdensome requirements. Donors are attracted to this type of organization because it bestows generous tax benefits associated with donating directly to charities. The tax benefits are allowed, given the fact that the donor renounces control over the donations provided but at the same time is able to appoint the organization's board, thereby, enabling the donor to potentially maintain significant control over the monies.

The number of supporting organizations has grown from 24,000 in 1995 to 34,000 with 400 of the largest controlling $76.7 billion in assets in 2001, according to the National Center for Charitable Statistics at the Urban Institute, a research group. The center also ascertained that one-quarter of those 400 organizations made no grants in 2001 and an additional 22 percent depleted less than 3 percent of their assets on charity. Supporting organizations are not required to disburse a certain average percent of assets per year. (In contrast, private foundations are required to disburse an average of 5 percent of their assets a year.)

As such, regulators and lawmakers are looking to make the rules tougher to cut down on the number of wealthy donors using this type of organization as a form of tax planning instead of for charitable giving. The IRS is currently auditing 100 supporting organizations and their donors and has revoked the tax exemption of at least one supporting organization. The IRS is considering penalties on promoters of these organizations and is examining a few cases for possible criminal investigation. Furthermore, the IRS commissioner has additional concerns regarding supporting organizations, citing donations of assets held in off-shore tax havens that find their way back into the donors' pocket and the challenge of determining whether the values the donors are placing on unconventional gifts for tax purposes are valid.

IRS.gov

The IRS has recently added Lifecycle, a valuable resource, to its Web site.

Another valuable tool the IRS has added is the EO Update, which updates subscribers via e-mail when changes occur in that sector.

Other new resources are available on the IRS Web site for charities and other tax-exempt entities with paid employees. The Employment Taxes for Exempt Organizations Web page includes information about how to determine if a worker is a volunteer, contractor, or employee, and what the respective withholding and filing requirements are for organizations. In addition, employers can download tax forms and publications, and other resources.

New Tax Law Promotes Tsunami Relief Contributions

The IRS notified taxpayers who itemize deductions that they are entitled to claim charitable donations made for the victims of the Indian Ocean Tsunami in 2005 on their 2004 tax returns. The new law was enacted on January 7, 2005, to permit these donations as if they were made on December 31, 2004. This law is only applicable to cash contributions. Readers should note that this exception by the IRS does not change the generally accepted accounting principles (GAAP) requirements for not-for-profits regarding recording contributions in the period made or received.

IRS Issues Donated Vehicle Publications

The IRS has published two publications to help provide guidelines for donated vehicle programs, effective for donations made *before* December 31, 2004. In addition, the IRS and Treasury Department have issued guidance on charitable deductions for donated vehicles. Notice 2005-44 explains new rules adopted in the American Jobs Creation Act of 2004, which (1) generally limits the deduction to the actual sales prices of the vehicle when sold by the donee charity, and (2) requires donors to get a timely acknowledgment from the charity to claim the deduction. The Notice is available on the IRS Web site at www.irs.gov/pub/irs-drop/n-05-44.pdf.

Publication 4302, *A Charity's Guide to Car Donations*, provides guidelines for charities that operate car donation programs. The guide can help answer the following questions:

- What tax consequences may arise as a result of how a charity operates a car donation program?
- How can the car donation program affect a charity's exempt status?
- How can the car donation program affect the tax deductibility of the donor's contribution?
- What are the common types of car donation programs and the tax consequences for a charity and its contributors?
- What are the filing and disclosure requirements?
- What are the state law requirements?

Publication 4303, *A Donor's Guide to Car Donations*, provides guidelines for individuals who donate their cars.

These publications are available online at the IRS Web site at www.irs.gov/charities/article/0,,id=132520,00.html.

IRS Issued 2005 Inflation-Adjusted Numbers—Insubstantial Benefit Limitations for Contributions Associated With Charitable Fund-Raising Campaigns

By factoring inflation into the tax rates and certain other amounts, the law protects taxpayers from losing the value of various benefits. Each fall, the IRS issues a document detailing the results of these adjustments for the coming year (Revenue Procedure 2004-71).

Low-Cost Article. During the normal course of business, charitable organizations are permitted to dispense low-cost articles relating to a fund-raising campaign that will not be considered unrelated business income by the IRS. For taxable years beginning in 2005, the unrelated business income of certain exempt organizations under IRC section 513(h)(2) does not include a "low-cost article" with a value of $8.30 or less.

Other Insubstantial Benefits. As a general rule, a donor's contribution must be reduced by the value of the goods or services received in return for the donation to calculate the deductible portion. Nevertheless, an insubstantial benefit can be disregarded if the gift meets the requirements for claiming a write-off, therefore permitting a full deduction. Readers should refer to the alternative limitations used to determine if the benefits meet the standards for "insubstantial value" set out in Rev. Proc. 90-12, 1990-1 C.B. 471, and Rev. Proc. 92-49, 1992-1 C.B. 987 (as updated). For taxable years beginning in 2005, the guidelines in section 3 of Rev. Proc. 90-12, 1990-1 C.B. 471 (as amplified and other insubstantial benefits modified), for disregarding the value of insubstantial benefits received by a donor in return for a fully deductible charitable contribution under IRC section 170, have been raised from $5 to $8.30, $25 to $41.50, and $50 to $83.

Reporting Exception for Certain Exempt Organizations With Nondeductible Lobbying Expenditures. For taxable years beginning in 2005, the annual per person, family, or entity dues limitation to qualify for the reporting exception under IRC section 6033(e)(3) (and section 5.05 of Rev. Proc. 98-19, 1998-1 C.B. 547), regarding certain exempt organizations with nondeductible lobbying expenditures, is $88 or less.

Readers may refer to the entire document at www.irs.gov/pub/irs-drop/rp-04-71.pdf.

Sarbanes-Oxley Act and Not-for-Profits

Auditors are reminded yet again that all organizations, not-for-profits included, are being held to higher standards of accountability than ever before. The fund-raising ability of not-for-profits can be harmed as a result of negative public perceptions brought on by business and accounting scandals.

As discussed in last year's Alert, although with very limited exceptions, the Sarbanes-Oxley Act is applicable only to public companies and their auditors; it has been having a cascade effect on not-for-profit organizations. This is becoming more apparent as public company governance reforms continue to permeate the not-for-profit sector. As more proposed legislation is announced for not-for-profits that mimic certain sections of Sarbanes-Oxley, some not-for-profits are adopting provisions that they believe are best practices that will improve the not-for-profit's governance. Some not-for-profits are considering adopting such public company governance reforms as the CEO/CFO certification of financial statements, increased disclosures, increased role of the audit committee, and code of conduct rules for CFOs and other senior financial officers, which are the least costly of the reforms. Some are also considering implementing increased audit committee oversight of auditors, restrictions on executive compensation and establishment of independent directors, independent director approval of related party transactions, and the establishment of fraud/misconduct procedures. These reforms are being introduced in the hopes of bolstering donor confidence in charitable giving by requiring not-for-profits to comply with more governance and accountability standards.

Various states are considering proposed legislative reforms. A discussion regarding some of those states is included here.

NY Proposed Not-for-profit Legislative Reforms

The New York Attorney General's Office has proposed revised legislative reforms for not-for-profit organizations. Similar legislation was introduced last year but did not pass. The 2005 proposals include additional disclosure requirements relating to contracts between not-for-profit corporations and their board members; new authority to the attorney general's office for the removal of directors or officers engaged in failure to file complete and accurate annual reports; and a suggestion that not-for-profits consider implementing audit committees and understand their internal financial controls. For further details regarding the New York proposals, go to www.oag.state.ny.us/charities/legislation.html.

R.I. Proposed Not-for-Profit Legislative Reforms

In Rhode Island, bill H-6014 introduced in March 2005 proposes that any not-for-profit, with the exception of hospitals, that pays its directors or officers more than $200,000 per year may not be entitled to not-for-profit status. Readers may read the bill at www.rilin.state.ri.us/Billtext/BillText05/HouseText05/H6014.pdf.

Mass. Proposed Not-for-Profit Legislative Reforms

As discussed in last year's Alert, in March 2004 the Massachusetts Attorney General's Office issued proposed legislation to improve charity accountability and transparency; the legislation is currently still in draft form.

Legislative Activities Aimed at Strengthening Governance and Accountability Turn Into New Legal Requirements

The Nonprofit Integrity Act of 2004 (California)

As discussed in last year's Alert, several states proposed new accountability regulations that would apply many of the concepts of the Sarbanes-Oxley law to charities. California was one of those states whose Attorney General's Office proposed legislative reforms in February of 2004 to strengthen accountability and oversight of not-for-profit organizations.

As a result, Senate Bill 1262, known as the Nonprofit Integrity Act of 2004, became law in February 2004. The Act imposes new requirements on the conduct of most charities, commercial fund-raisers, fund-raising counsels, unincorporated associations, and trusts. Educational institutions, hospitals, cemeteries, and religious organizations are excluded from the act. However, be aware that it may cover organizations headquartered outside California but conducting activities in California.

Financial statement audits are now required for those entities with $2 million or more in gross revenue for fiscal years ending June 30, 2005, and thereafter. Grant or contract income from the government is not included in the calculation of gross revenue as long as the government entity requires an accounting of those funds. See the instructions for all other gross revenue questions. The act also requires the establishment of audit committees, places certain requirements on audit committee membership, requires public disclosure of audit reports, and requires board approval of CEO and CFO compensation. The act took effect January 1, 2005. If your client is required to have an audit, the act has provisions affecting the size, composition, and activities of the audit committee.

California's attorney general has issued guidance and resources on the act, including FAQs and a guide to the new law at www.ag.ca.gov/charities.

American Jobs Creation Act of 2004

Vehicle Donations

On October 22, 2004, President Bush signed into law the American Jobs Creation Act (AJC Act) (HR 4520), which among many rules now disallows deductions for contributions of used motor vehicles, boats, and airplanes if the value exceeds $500 unless the taxpayer files with his or her tax return a written acknowledgment from the charity. If the charity sells the vehicle, without any significant use or improvement, the taxpayer's deductions will be limited to the gross proceeds from the sale. The charity must provide the taxpayer with a certification that the vehicle was sold at "arm's length" between unrelated parties and the sale price of the vehicle within 30 days of the sale. If the charity will not sell the vehicle, it must provide a receipt within 30 days. The charity, in certain circumstances, will also be required to certify and provide a document to the taxpayer stating how the vehicle will be used or improved, how long the charity will use the vehicle, and a promise not to sell or transfer the vehicle. The new law also imposes penalties on charities that fail to timely furnish the acknowledgment for a vehicle donation or for fraudulent acknowledgements provided to taxpayers. The new law became effective for contributions made after December 31, 2004.

Donation of Patents and Intellectual Property

The AJC Act also states that contributions of patents or other intellectual property, such as copyrights and software, to charitable organizations after June 3, 2004, are limited to a charitable deduction of the taxpayer's basis in the contributed property or its fair market value, whichever is less. The donor's basis is defined as what the donor spent to create the donated property. The donor is permitted to claim subsequent charitable deductions for up to 12 years based on a specified percentage of the income the charity receives with respect to the donated property. One hundred percent of the additional income is permitted as a deduction in the first year after the contribution. The percentage gradually decreases to 10 percent of the additional income in the twelfth year. A deduction for increased income is permitted only if it exceeds the value of the initial deduction. Additional deductions are not permitted for donations of patents or intellectual property to private foundations.

The charity must report to the IRS income received with respect to the contributed property. The donor must obtain written substantiation from the charity regarding any income from the donated property.

Noncash Donations

The new provision applicable to individuals will extend to all C corporations. The donor must obtain a qualified appraisal of the property being donated for deductions over $5,000. It also requires that all donors attach the appraisal to their tax return if the contribution exceeds $500,000. This provision became effective for contributions made after June 3, 2004.

Nonqualified Deferred Compensation

The AJC Act also imposes significant restrictions on compensation deferral elections, benefit distribution provisions, and plan funding alternatives for nonqualified deferred compensation (NQDC) programs, which include tax-exempt organization plans. Not-for-profit organizations that offer NQDC plans should have the plans reviewed since they are most likely noncompliant due to the substantive changes made to the deferred compensation tax laws. The new rules became effective for amounts deferred in taxable years beginning December 31, 2004, and any amounts not vested as of December 31, 2004.

Congressional Oversight—U.S. Senate Finance Committee Hearings on Oversight and Accountability

In June 2004, the Senate Finance Committee began a series of hearings on potential reforms needed in the sector. The committee staff issued a draft white paper outlining some of these areas with potential solutions. On April 5, 2005, the Senate Finance

Committee held another hearing, this one focused on "Charities and Charitable Giving: Proposals for Reform." In Chairman Charles Grassley's (R-Iowa) opening remarks, he stated that Congress has not reviewed the laws governing charities since 1969. Currently, the tax-exempt and government sector of the economy encompasses approximately three million entities that control approximately $8 trillion in assets and pay over $300 billion in employment tax and employee income tax withholding.

At the hearing, a letter from IRS Commissioner Mark Everson was discussed that outlines compliance issues within the responsibility of the Tax Exempt and Government Entities Division (TE/GE) of the IRS. Commissioner Everson noted that one of the four key objectives of the IRS Strategic Plan for 2005–2009 focuses directly on the tax-exempt and government entities sector: To deter abuse within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance or other unintended purposes.

Other areas discussed at the hearing included:

- Possible changes to deductions for noncash gifts, including clothing, property, and conservation easements
- Increased ability for sharing of information between the IRS and state regulators
- Implementing a five-year review of the exempt status of public charities and private foundations
- Mandatory electronic filing of Forms 990 and 990-PF
- Continuing the examination of compensation and benefits in the not-for-profit sector
- Issues of concern regarding donor-advised funds and Type III supporting organizations

Independent Sector

In response to the Senate Finance Committee's first hearing and staff draft white paper, the Panel on the NonProfit Sector, convened by the Independent Sector, submitted an interim report to the committee on March 1, 2005, that contained a series of recommendations to enhance accountability and governance of charitable organizations. In the interim report, the panel focused on four areas:

- Actions the sector can take on a voluntary basis to improve governance and ethical conduct
- Ways to increase the transparency of charitable sector operations
- Additional legislation that is necessary to ensure that tax-exempt dollars are used exclusively for charitable purposes
- Stronger enforcement of existing law by federal and state oversight officials

The report also made an effort to provide estimated figures for audit costs. Obviously, audit costs vary based on a not-for-profit's location, size, and type.

The Panel on the Nonprofit Sector addresses additional issues discussed at the hearing, such as compensation policies, revisions to IRS filings documents, accounting standards, and valuation of noncash contributions, in its upcoming phase II report to the Senate Finance Committee, scheduled for mid-June 2005. Readers can follow the panel's progress at www.nonprofitpanel.org/.

House Ways and Means Committee

In April 2005, the House Ways and Means Committee held a hearing on the charitable sector as well. Issues of what is tax-exempt status and how this has evolved since 1969 were discussed. Although no proposed legislation or staff white papers have resulted, the House has indicated it will continue to monitor areas of potential reform in the sector.

Readers should continue to closely monitor the progress of this proposed legislation to stop abuses by public charities. Furthermore, organizations may consider assessing their own governance, disclosures, and compliance with the tax laws to ensure they are operating to execute their exempt purpose.

Joint Committee on Taxation Report

The Congressional Joint Committee on Taxation's report *Options to Improve Compliance and Reform Tax Expenditures* was released in January 2005. The report, requested by the Senate Finance Committee, covers a range of proposals designed to raise revenue to fill the gap between taxes owed and collected.

Included in the 435-page report are a number of recommended changes to laws governing charities:

- Conduct a five-year review of the exempt status of public charities and private foundations.
- Impose a termination tax on conversions of assets of charities.
- Reform rules for charitable contributions of property.
- Establish additional exemption standards for credit counseling organizations (IRC sections 501(c)(3) and 501(c)(4)).
- Reform intermediate sanctions and extend certain reforms to private foundations.
- Modify charitable deduction for contributions of conservation and facade easements.
- Tax involvement by exempt organizations in tax-shelter transactions
- Increase the excise tax on self-dealing.
- Limits on deductions for donations of clothing and household items.

Readers may find the report in its entirety at www.house.gov/jct/s-2-05.pdf.

CARE Act Reintroduced in Senate

On January 24, 2005, Congressman Rick Santorum (R-Pa.) introduced proposed legislation (S. 6) that included the Charity Aid, Recovery and Empowerment (CARE) Act, which contains provisions that encourage charitable giving. The CARE Act was listed as one of Senate Majority Leader Bill Frist's (R-Tenn.) top 10 priority bills for the 109th Congress.

In the 108th Congress, the CARE Act and a companion bill H.R.7 (the Charitable Giving Act of 2003), passed the House with overwhelming support but never made it to a conference committee.

The proposed legislation includes numerous tax incentives for charitable giving, including the following:

- Non-Itemizer Deduction, allowing individuals who do not itemize to deduct a portion of their charitable contribution ($250 and above for individuals, $500 for joint filers up to a ceiling of $500 for individuals/$1,000 for joint filers)
- IRA Rollover, allowing tax-free distributions to charities from individual retirement accounts (IRAs) (donors age 59½ and older may roll amounts from traditional or Roth IRAs to create life income gift to charity; donors 70½ and older can direct cash contributions to a charity.)
- Charitable deductions for contributions of food and book inventories; scientific property used for research, artistic, or scholarly compositions; and incentives for land for conservation purposes
- Adjustment to the basis of corporate stock for certain contributions
- Simplified and improved rules for charity lobbying
- Improved oversight of charitable organizations, including expanded IRS public disclosure requirements and the requirement that the IRS notify the public that copies of Form 990 submissions are publicly available
- Compassion Capital Fund, authorizing $150 million in fiscal year 2003 for technical assistance and capacity building grants for "community organizations" to be distributed by federal agencies

As of the writing of this Alert, the differences between the CARE Act and H.R. 7 were not resolved and the House has not reintroduced H.R. 7. For a detailed comparison of the charitable tax incentive provisions in the prior House and Senate bills, go to www.independentsector.org/PDFs/sidebyside03.pdf.

Uniform Management of Institutional Funds Act

As mentioned in last year's Alert, a drafting committee of the National Conference of Commissioners on Uniform State Laws (NCCUSL) is drafting proposed revisions to the Uniform Management of Institutional Funds Act (UMIFA). (A uniform act is well-researched and drafted legislation proposed for enactment in the states. It deals with areas of the law in which uniformity is desirable and practical. States may adopt a uniform act with modifications as determined by each particular state. Until adopted by a state, a uniform act is not law in that state.) The original UMIFA, which was drafted in 1972 and has not been revised since, has been adopted with or without modification in 47 states and in the District of Columbia.

UMIFA is significant to the accounting and reporting of endowment funds in conformity with GAAP. For example, paragraph 22 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, provides as follows:

> A statement of activities shall report gains and losses recognized on investments and other assets (or liabilities) as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or by law. For example, net gains on investment assets, to the extent recognized in financial statements, are reported as increases in unrestricted net assets unless their use is restricted to a specified purpose or future period. If the governing board determines that the relevant law requires the organization to retain permanently some portion of gains on investment assets of endowment funds, that amount shall be reported as an increase in permanently restricted net assets.

In states that have adopted its provisions, UMIFA is the relevant law that a governing board considers when determining whether the organization must retain permanently some portion of gains. Also, in states that have adopted UMIFA, a correlation generally exists between the historic dollar value of an endowment fund and the balance reported as permanently restricted net assets for that fund. If UMIFA was adopted without modification, historic dollar value is the value of the original contribution at the date of the gift adjusted for additional contributions and any other amounts the donor or a law required to be added to those gifts.

In its most recent version (the March 2005 draft), the Drafting Committee for the revised Uniform Management of Institutional Funds Act (RUMIFA) has replaced the historic dollar value approach for expenditure of endowment funds with a new standard of prudence that applies to the decision-making process of the governing board. Acting prudently and in good faith, the governing board must consider a number of factors in deciding how much to distribute from an endowment fund. Those factors include the duration and preservation of the endowment fund, the purposes of the institution and the endowment fund, the possible effect of inflation or deflation, the total return of the investments, the institution's investment policies, the availability of other resources, and general economic conditions.

Thus, RUMIFA would provide more flexibility to the persons at the institution making decisions about expending funds. That flexibility typically would be particularly useful in the early years of an endowment fund, when there is little or no accumulated appreciation that would be available for spending under UMIFA. The intent is not to allow a governing board to convert an endowment fund into a totally expendable fund, but rather to encourage the governing board to preserve the purchasing power of the current value of an endowment fund, while being responsive to the needs of the institution during short-term fluctuations in the value of the fund. RUMIFA does not require that a specific amount be set aside permanently as "principal"; however, the act assumes that the charity will act to preserve principal (that is, to maintain the purchasing power of the fund) while spending "income" (that is, making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions).

To that end, the Drafting Committee has added in RUMIFA a rebuttable presumption of imprudence if the governing board appropriates in any one year an amount greater than 7 percent of the fair market value of the endowment fund, calculated on the basis of market values determined at least quarterly and averaged over the three-year period immediately preceding the year in which the expenditure was made.

It is unclear how the changes proposed in RUMIFA would affect the classification of an endowment fund's net assets. Some believe removing "historic dollar value" as an amount that must be maintained in perpetuity has the potential of eliminating all permanently restricted net assets of an endowment fund unless the donor explicitly required some portion of the endowment fund to be retained permanently. However, others believe increasing a governing board's legal responsibility to preserve the purchasing power of the endowment fund (similar to existing laws in Rhode Island) has the potential of increasing the amount of permanently restricted net assets. (For more information, see paragraph 128 of FASB Statement No. 117.) Further, some believe including a presumption of imprudence for spending more than 7 percent of a rolling average of an endowment fund's fair market value has the potential of creating a time restriction on the remaining endowment value because that remainder is unavailable for spending under ordinary circumstances.

We expect the profession to monitor the enactment of RUMIFA and collectively determine how it should be interpreted—just as it did for UMIFA when FASB Statement No. 117 was issued. If a state eventually enacts RUMIFA, consultations between counsel, the state audit society, industry associations, the attorney general, and other interested parties should help to arrive at common understandings of the revised law.

In May 2004, Florida enacted a version of UMIFA that emphasizes conserving the purchasing power of the endowment fund, rather than maintaining the historic dollar value of the fund (Fla. Stat. ch. 1010.10). That statute was based on an early draft of RUMIFA. The law applies only to institutional funds that are held by K-20 educational institutions. Educational institutions and their auditors are now going through the process of determining the effects of the new law on classification of net assets.

The National Conference of Commissioners on Uniform State Laws is endeavoring to issue a revised Act in the summer of 2005. Readers can access the most current draft of RUMIFA at www.nccusl.org.

The Better Business Bureau Wise Giving Alliance

The Better Business Bureau (BBB) Wise Giving Alliance is a charity watchdog whose objectives include assisting donors in making knowledgeable and informed giving decisions. As discussed in a prior year's alert, the Alliance issued new charity accountability standards in March 2003.

Since then the BBB Wise Giving Alliance has developed its first Implementation Guide to the BBB Wise Giving Alliance Standards for Charity Accountability. The Implementation Guide has been prepared to help users understand the BBB Wise Giving Alliance Standards of Accountability and how the Alliance will apply them in evaluating charities. For each of the 20 standards, there are three key sections:

1. *Effective date*—This section includes the date on which the Alliance will begin using that standard in its evaluations.
2. *Information needed from charity to determine compliance*—This section specifies the basic information or items that charities will need to provide for an Alliance review.
3. *Application*—This section describes the criteria and procedures the Alliance will use in evaluating the information it receives.

Furthermore, there is an index to help users locate references to particular requirements or items related to the standards.

Because this is the first Implementation Guide on the new standards, the Alliance is soliciting comments and suggestions from charities that will be reviewed by the Alliance in anticipation that revisions to the initial Implementation Guide will be needed. The Implementation Guide can be viewed or downloaded at the BBB Web site, www.give.org/standards/.

The National Committee on Planned Giving Guidelines for Reporting and Counting Charitable Gifts

In March 2005, the National Committee on Planned Giving (NCPG) released final Guidelines for Reporting and Counting Charitable Gifts. The Guidelines for Reporting and Counting Charitable Gifts were developed to provide a tool for charitable organizations to evaluate the results of fund-raising activity to external constituencies such as the media, donors, and other charities. The guidelines do not apply to reporting contributions in financial statements.

The new guidelines complement NCPG's Valuation Standards for Charitable Planned Gifts, which were released in April 2004 and discussed in last year's Alert. The Valuation Standards are for *internal* use to help charitable organizations in comprehending the future purchasing power of a planned gift, whereas the Guidelines for Counting and Reporting Charitable Planned Gifts permit organizations to report all their fund-raising results and in particular, gift planning achievements to *certain external* constituencies.

Readers may view the guidelines by going to www.ncpg.org/ethics_standards/counting_gifts.asp?section=7.

Note: These guidelines are not in conformity with U.S. GAAP for financial reporting purposes. GAAP guidance is set forth in FASB Statements No. 116 and No. 117 and in the NPO Guide, Chapter 6 in particular.

American Society of Association Executives Report on Not-for-Profit Governance

In response to the Sarbanes-Oxley Act (Sarbanes-Oxley), an increasing amount of interest on charitable oversight and not-for-profit governance at the federal and state levels occurred. The not-for-profit sector saw the new law as one model for not-for-profit governance standards given that it addresses many processes and practices that may have relevance for not-for-profits. Only two provisions of Sarbanes-Oxley require compliance by not-for-profit organizations: those dealing with document destruction and whistle-blower protections.

In January 2004 the New York Society of Association Executives (NYSAE) Education & Research Foundation and the American Society of Association Executives (ASAE) hosted a National Consensus Conference on Nonprofit Governance, which was co-sponsored by Wachovia, the AICPA, and Arent Fox. The conference was created as a forum for not-for-profit leaders to address the increasing consideration being given to the governance standards of their organizations. In addition, the conference was created to talk about measures that could be taken to voluntarily enhance not-for-profit leaders' fiduciary practices and accountability to members, donors, grantors, and other stakeholders.

The ASAE released a report entitled *Changing Expectations for Nonprofit Organization Governance* as a result of that conference. The report's goal is to provide organizations with a starting point for taking into account their own governance practices and evaluating whether they are adequate.

The report can be found on the ASAE's Advocacy Web site, managed by Capitol Advantage, at ffs.capwiz.com/asae/ChangingExpectations_Governance_Rept9_9_04.pdf.

U.S. Postal Service Adopts Rule on Use of Personal Information in Standard Mail

The U.S. Postal Service (USPS) has adopted a new rule to clarify the circumstances in which mail containing personal information may be eligible for the standard mail rate as opposed to the first-class mail rate. The rule is effective June 1, 2005. A mailing containing personal information may be sent as standard mail if all three of the following conditions are met:

1. The mailing contains explicit advertising or solicitation for a donation.
2. All the personal information contained in the mailing is directly related to the advertising or solicitation.
3. The exclusive purpose of the personal information is to support the advertising or solicitation.

The USPS Customer Support Ruling (PS-323) includes descriptive examples of solicitations containing personal information that can be sent at the nonprofit standard postage rate rather than the first class rate. It can be found at www.nonprofitmailers.org/tools/ps323.pdf.

Not-for-profits had expressed opposition to the proposed rule because it would have required not-for-profits to send "dual purpose" mailings, such as a newsletter that also includes a personal solicitation, at more expensive first-class rates. Of the 402 written comments received on this rule, 350 of them were from not-for-profit organizations. More information on this issue can be found at www.nonprofitmailers.org/junerule.html.

Audit and Attestation Issues and Developments

Auditing E-Philanthropy

The Internet, as a communications and direct response channel, is being used by large and small not-for-profits to develop strong constituent relationships to maximize fund-raising efforts. Not-for-profits can use the Internet for marketing services, driving advocacy, recruiting volunteers, and acquiring and retaining both annual giving and major donors. As the Internet has proven to be a powerful tool for helping not-for-profits raise significant dollars, the auditor faces new challenges.

Audit Timing and Planning

Not-for-profits with online donation transactions may automatically initiate, authorize, record, summarize, and settle transactions electronically without human intervention or physical documentation. As a result, key audit evidence in electronic form may exist only for a limited amount of time. Therefore, auditors will need to understand and be able to rely on information technology (IT) general controls. Computer programs may summarize transactions on a periodic basis and then purge, update, change, modify, or write over the original detail records of the transaction. Traditionally, audit procedures are performed after a client's fiscal year-end. With Internet activities, however, traditional audit timing may be inadequate. One audit implication of sometimes short-term electronic evidence in audits of not-for-profits with online donations is that waiting until after the fiscal year-end to begin auditing procedures may be too late to obtain competent sufficient evidence of controls or transactions.

SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.09), as amended, indicates that "the extent to which computer processing is used in significant accounting applications, as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures."

The not-for-profits conducting e-philanthropy may not have hard-copy or paper evidence of transactions. Contribution statements, delivery, settlement, and authorization may be prepared and performed electronically, leaving no paper trail behind. The failure of not-for-profits to retain the details of transactions can create troublesome issues for the auditor who is considering whether internal control is functioning as planned. According to SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.18), as amended:

> Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Therefore, the auditor should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and if applicable, tests of controls.

If the retention of evidential matter is questionable, the auditor may want to begin audit procedures before year-end. This may also drive the need for continuous auditing.

Adequate Technical Training

The rapid evolution of technology has profound implications for all those affected by computer technology, including auditors. Existing not-for-profit e-philanthropy hardware and software may need to be replaced every 18 months, or more frequently, to remain competitive. This rapid rate of technological change means that, to remain current, ongoing training in the underlying Internet technologies is requisite.

Auditing through the computer and the nature of electronic evidence require that the auditor gain a more detailed understanding of the controls over transactions and records than that traditionally obtained for paper-based manual audits. Auditors can obtain more specific technology skills through technical training courses, seminars, information technology (IT) reference materials, research, and other methods.

Using the Work of a Specialist

Due to the rapid advance of technology, auditors may not have all the skills necessary to audit online activities. Until auditors have the technical skills needed to audit not-for-profit e-philanthropy of online donations, auditors may need to engage IT audit specialists to perform certain procedures. Qualified IT specialists are sometimes available from another part of the firm, such as the consulting division or the internal IT support staff. If not, auditors may have to go outside their own organizations to obtain qualified specialists. Engaging a specialist for gaining an understanding of internal controls, tests of controls, substantive tests, and analytical procedures requires awareness of guidelines available in the authoritative literature. According to SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336.06), specialized assistance is advisable for auditors who:

> …may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skills or knowledge and in the auditor's judgment require using the work of a specialist to obtain competent evidential matter.

The use of an outside specialist[3] in an Internet context does not absolve the auditor from a certain level of understanding about computers. Audit planning comes into play because of the lead time necessary to contract for a specialist's services and the time

3. Note that Statement on Auditing Standards No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), does not apply to specialists who are employed by the firm and are part of the engagement team.

required for the auditor to obtain the minimum technological knowledge necessary to supervise the specialist. According to SAS No. 22 (AU sec. 311.10):

> If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.

Ethics Interpretation No. 101-3 and Management Representation Letters

As discussed in last year's Alert, the AICPA revised Ethics Interpretation 101-3, "Performance of Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), which modifies the practitioner's responsibilities for maintaining independence when providing nonattest services (for example, tax or consulting services) to attest clients. This Interpretation is important and should be thoroughly understood by practitioners. Refer to the *Independence and Ethics Alert—2004/05* (product no. 022475kk) for further information. The Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Ethics Interpretation 101-3 provides that if the client lacks the competence to understand certain functions necessary to generate GAAP financial statements, such as developing and posting certain journal entries, the auditor cannot develop and post those journal entries (or perform certain other functions) because doing so would impair the auditor's independence. Accordingly, in such situations management may hire a third party (other than the auditor) to perform those tasks to generate GAAP financial statements. This situation may result in unintended consequences and many auditors may be unaware of these consequences.

Risks and issues include the following:

- In circumstances in which management lacks the competence to understand certain functions necessary to generate GAAP financial statements, management likely would be unqualified to represent that the financial statements are prepared in conformity with GAAP. The third-party CPA handling the functions that management lacked the competence to perform may fail to sign the management representation letter.
- The third-party CPA, making representations to the auditor in the management representation letter, may not clearly communicate the scope of his or her services.
- In circumstances in which a third-party CPA is signing the management representation letter using wording representing that he or she believes the financial statements are fairly presented in conformity with GAAP, yet making it clear that he or she did not audit the financial statements, that third-party CPA may be issuing a compilation report. If so, the compilation report may fail to state that the third-party CPA is not independent.

Some auditing considerations include the following:

- Auditors need to understand and comply with the requirements of SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended.
- Auditors may need to ask management to have the third-party CPA that is helping management prepare financial statements sign the management representation letter.
- When a third-party CPA signs the management representation letter, his or her scope of services must be clearly communicated.
- CPAs issuing compilation reports need to understand and comply with the provisions of AICPA Ethics Interpretation 101-3 and disclose a lack of independence in their compilation reports if necessary.

For further guidance, readers may refer to the two following ethics documents issued by the AICPA to help practitioners when applying Interpretation No. 101-3: (1) *Requirement to Document Understanding With an Attest Client* (go to www.aicpa.org/download/ethics/Int._101-3_documentation_guidance.pdf to download the document) and (2) *Guidance in Understanding General Requirement No. 2: Client Responsibilities* (go to www.aicpa.org/download/ethics/101-3_Competency_Guidance.pdf to download the document).

Outsourcing

Many not-for-profits are increasingly outsourcing various and more sensitive business functions, either to enhance revenues or to improve overall operational effectiveness, which assists in maintaining good donor relations. Furthermore, outsourcing helps not-for-profits plug into needed expertise and reduce internal staff costs. Outsourced functions include developing planned-giving strategies and marketing materials, IT, finance, accounting, working with donors and their advisers, administering split-interest gifts, data entry, transaction processing, telemarketing, managing the investment of assets, investment research, human resources, tax services, and call center operations.

Risks and issues related to not-for-profit outsourcing include the following:

- Transactions that affect the financial statements are subjected to controls that are, at least in part, physically and operationally separate.
- Less control of business function may occur, resulting in weakened internal control and security over systems.
- Training at the entity handling the outsourced work may be inadequate, possibly weakening internal control.
- Privacy of donor financial and other personal data may be compromised. The organization that outsourced the work is legally responsible.

- Management's and auditors' understanding and assessment of internal control may need to encompass controls at service organizations handling the outsourced work. Circumstances may impair that understanding and assessment.

Some auditing considerations related to not-for-profit outsourcing include the following:

- Consider and comply with the auditing requirements of SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended.
- Consider and comply with the auditing requirements of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337), and SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317), in response to the increased legal risk associated with outsourcing.

In addition to not-for-profit outsourcing, the AICPA has adopted new ethics rules that place new requirements on members who outsource work.

Two new rules and one revised rule spell out the responsibilities AICPA members now must meet when outsourcing clients' work to third-party providers. The definition of third-party service providers has been broadened beyond an outside tax service bureau to any third-party service provider used by AICPA members, including independent contractors used by a CPA firm.

The new requirements state that AICPA members must inform their clients, preferably in writing and before providing confidential client information to the third-party service provider that the firm will use a third-party service provider when providing professional services to the client. The new rules also clarify that AICPA members are responsible for all work performed by the service provider.

Furthermore, AICPA members using third-party service providers are required under the new rules to enter into a contractual agreement with the third-party service provider to maintain the confidentiality of the client's information and to be reasonably assured that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information. New rules are effective for all professional services performed on or after July 1, 2005, except for professional services performed pursuant to agreements in existence on June 30, 2005, that are completed by December 31, 2005. Early application is encouraged. The new standards are available at: www.aicpa.org/download/ethics/2004_1028_outsourcing.pdf.

Auditing Gifts-in-Kind

Some not-for-profit organizations receive in-kind contributions, such as donations of food and clothing. Chapter 5 in the NPO Guide includes guidance for accounting for such in-kind contributions. Also see "Accounting for PPE and Inventory Received as Gifts-in-Kind" in the next section of this Alert.

An auditor at a not-for-profit organization may need to use a specialist's work in order to obtain competent evidential matter about the valuation of gifts in kind. SAS No. 73, *Using the Work of a Specialist*, provides guidance when an auditor uses the work of a specialist.

Special Fraud Advice for 2005

Not-for-profit organizations can be prime targets for fraudulent financial reporting and misappropriations of assets. The following conditions can leave not-for-profits susceptible to fraud: (1) high fund-raising and performance goals, (2) volunteers often handling money and keeping accounting records and (3) lack of segregation of duties in handling cash and noncash contributions, bank and investment accounts, and expenditure of funds. Grants and donor-restricted funds put not-for-profits in the public eye. Auditors should fulfill their responsibilities under SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). Furthermore, according to the AICPA Professional Liability Insurance Program audit, the cause of the loss for 40 percent of the claims for not-for-profit entities for the period 1995 to 2000 was theft by client employees. Here are some of the red flags:

- *Budget cutbacks.* When a not-for-profit operating on fund-raising dollars and volunteer leadership cuts back by reducing its paid workforce, financial controls usually suffer and the remaining employees or unpaid volunteers must pick up the slack, which in turn can lower morale and increase the likelihood of fraud among unhappy workers.

- *Refusal to take legitimate perks.* When employees or volunteers are involved in an ongoing embezzlement scheme, they often do not take vacation time or offered promotions so they can continue to hide their theft.

- *Bounced checks.* If the not-for-profit's board of directors knows the organization has enough funds to cover its expenditures and checks continue to bounce, chances are good the entity may be a victim of some kind of fraud.

- *Overemphasis on short-term fund-raising goals.* When board members, officers, or executives become too concerned with raising additional contributions, they often deemphasize internal controls and accurate financial reporting, leaving room for fraudsters to step in.

- *Poorly monitored remote event or promotional locations.* Fraud often proliferates wherever supervision and control are at a minimum, for example, during major fund-raising events such as benefits. This is particularly true when organizations acting without proper accounting supervision fail to create a paper trail with prenumbered tickets, receipts, and the like.

- *Things do not add up.* If staff members or volunteers are working on the organization's books and things do not make sense, you need to take a closer look.

- *Anonymous tips.* Fraud warnings can come in the form of telephone messages or anonymous letters from employees or volunteers. While warnings sometimes may be frivolous and without merit, not-for-profits cannot afford to ignore them.

- *Lifestyle or behavior changes.* An obvious discrepancy between an employee's earnings and how he or she lives can be a red flag for fraud. If a person's behavior suddenly changes, he or she may be under severe pressure because of fraudulent activity.

- *Inattention to details.* An organization that does not check account balances daily and reconcile bank statements immediately is inviting embezzlement, i.e., not-for-profits that do not employ other controls, such as scanning paid bills for possible overpayments, spot-checking financial records without advance warning, and reviewing mail before it is opened.

- *Not conducting background checks on anyone handling money.* This is especially true for volunteers, who are frequently not scrutinized as closely as employees.

- *Not-for-profit donations not being used for intended purposes.* This is especially important in light of the scandal at United Way of the Bay Area, in which PipeVine, a spinoff organization, closed in 2003 after it was discovered that some donations directed to charities actually went to PipeVine's day-to-day operations.

Auditors should refer to the NPO Guide, Chapter 2, Appendix A, "Consideration of Fraud in a Financial Statement Audit," for guidance on fulfilling their responsibilities under SAS No. 99. Moreover, the AICPA Practice Aid *Fraud Detection in a GAAS Audit, Revised Edition* (product no. 006615kk) provides practical, not-for-profit-specific help on considering fraud in a financial statement audit.

Also see the AICPA's Antifraud & Corporate Responsibility Resource Center at www.aicpa.org/antifraud, an online resource providing comprehensive tools, information, and resources devoted to the prevention, detection, and investigation of fraud.

Additionally, readers should be aware of Interpretation No. 26, "Communicating Possible Fraud and Illegal Acts to Management and Others," of Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Finan-*

cial Statements (AICPA, *Professional Standards*, vol. 2, AR sec. 100.100–.103), which addresses the question, "When an accountant suspect's fraud or illegal acts may have occurred, how should the accountant communicate possible fraud in both compilation and review engagements?" The Interpretation states that the accountant should communicate the matter to the appropriate level of management, unless the matter is clearly inconsequential. So, if the suspected fraud involves senior management, the accountant should communicate the matter to someone at the highest level within the not-for-profit organization. If the act involves the highest level of the organization, the accountant should consider resigning from the engagement and consult legal counsel.

Common Engagement Deficiencies

Following are some deficiencies commonly noted on not-for-profit engagements during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms. The list continues to include some of the same deficiencies identified in the past, indicating continuing problems with the same matters. Consider reviewing this brief list and then see if your not-for-profit engagements may have similar deficiencies:

- Failure to identify a voluntary health and welfare organization as such.
- Incorrect classification of contributions and related net assets as unrestricted, temporarily restricted, or permanently restricted.
- Failure to present a statement of cash flows (as required by FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*).
- Inadequate audit procedures to support the statement of functional expenses.
- Improper accounting for restricted funds.
- Inadequate format, titles, and presentation of financial statements.

Yellow Book CPE Credit

Readers are reminded that CPE courses that have been taken in regard to “404 report” audit work for Securities and Exchange Commission (SEC) clients do qualify for the 24-hour *Yellow Book* CPE credit according to the Government Accountability Office (GAO) CPE guidelines issued October 2004. Readers should go to the April 2005 version of the *Guidance on GAGAS Requirements for Continuing Professional Education* at the GAO Web site at www.gao.gov/govaud/ybcpe2005.pdf.

Understanding Audits, Reviews, and Compilations

Recent information suggests that some practitioners may misunderstand the difference between a compilation and review and an audit. Also, some not-for-profits are not aware that there is something “less than” an audit that might serve their needs.

In an audit, the financial statements are prepared by and are the responsibility of the not-for-profit’s management. The auditor’s responsibility is to express an opinion on those financial statements based on the audit. Generally accepted auditing standards (GAAS) requires that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Though this is a reasonable level of assurance, an audit does not provide a guarantee of accuracy.

Similar to an audit, the reviewed financial statements are prepared by and are the responsibility of the not-for-profit’s management. The primary difference between a review and an audit is that in an audit, the auditor verifies management’s amounts and disclosures with evidence provided by third parties. In a review, the CPA ordinarily does not verify management’s amounts and disclosures unless the CPA believes that the amounts and disclosures are materially inaccurate.

In a compilation, the CPA simply presents, in the form of financial statements, the client’s financial data and does not probe beneath the surface unless he or she becomes aware that the information management provided is in error or is incomplete. Similar to an audit and review, the compiled financial statements are the responsibility of the not-for-profit's management.

A compilation and review is performed in accordance with SSARS and the accountant has a responsibility to follow SSARS No. 1 (AR 100.01-.62).

Below is a very useful summary for practitioners to use.

Summary of an Audit, Review, and Compilation

Attribute	*Audit*	*Review*	*Compilation*
Engagement is performed for the purpose of providing an opinion or report about whether the financial statements are presented fairly in conformity vwith GAAP.	Yes, engagement performed to provide reasonable assurance	Yes, engagement performed to provide limited assurance	No, engagement provides no assurance
CPA obtains an understanding of internal controls over financial statements.	Yes	No	No
CPA tests the effectiveness of internal control.	Frequently, but not always. The nature and extent of internal control testing depends on the auditor's judgment and conclusions pertaining to risk assessment	No	No
CPA verifies certain balances and transactions with third parties.	Yes	No	No
CPA performs procedures to provide reasonable assurance that financial statements are free of material misstatements whether caused by fraud or error.	Yes	No	No
Financial statements are the responsibility of management.	Yes	Yes	Yes

Attribute	*Audit*	*Review*	*Compilation*
Financial statements are prepared by and are the responsibility of management.	Yes, but the CPA may assist in drafting.	Yes, but the CPA may assist in drafting.	Yes, but the CPA may assist in drafting.
CPA guarantees that the financial statements are accurate and free of fraud.	No	No	No
CPA evaluates the entity's policy decisions and use of resources.	No	No	No
CPA reports material weaknesses in internal control over financial reporting noted during the engagement to management and/or audit committee.	Yes	Not required, though frequently done if matters come to the CPA's attention	Not required, though frequently done if matters come to the CPA's attention
CPA acts as a whistleblower internally and reports identified fraud to management and/or audit committee.	Yes	Yes, unless clearly inconsequential	Yes, unless clearly inconsequential
CPA acts as a whistleblower externally and reports fraud and other matters to third parties, such as the IRS or state attorneys general.	No	No	No

Accounting Issues and Developments

The Importance of Documentation and Disclosure for Net Assets

A statement of financial position should report amounts for each of three classes of net assets (permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets) as well as total net assets. The three net asset classes should be based solely on the existence or absence of donor-imposed restrictions. The display of and disclosures about net assets and changes in them are intended to assist donors and other users, such as not-for-profit boards, in assessing an organization's efforts to provide goods and services to its constituencies, its efficiency and effectiveness in providing such services, and its continuing ability to do so. Making sure that documentation and disclosure are complete and accurate will help facilitate the board involvement in the organization.

Disclosure

A statement of financial position should include, at a minimum, the amounts of total permanently restricted, temporarily restricted, and unrestricted net assets and the amount of total net assets. A statement of activities should include the amount of total changes in net assets and of changes in each net asset class. These amounts should corroborate with the net asset amounts in the statement of financial position. Reclassifications of amounts between net asset classes should be reported separately from other transactions in the statement of activities. Specific changes in each net asset class should be aggregated into reasonably homogeneous groups.

Information about the following should be shown on the face of the financial statements or in the notes:

- Different kinds of permanent restrictions, such as those related to collection items and other specific assets to be held in perpetuity and to assets that have been contributed by donors with stipulations that they be invested in perpetuity
- Different kinds of temporary restrictions, such as those concerning the support of specific operating activities, use in specific future periods, or the acquisition of long-term assets

Separate disclosures of significant limitations other than those imposed by donors, such as those imposed by governing boards, are permitted to be made on the face of the financial statements or in the notes to the financial statements.

Paragraph 16 of FASB Statement No. 117 permits organizations to disclose self-imposed limitations on the use of unrestricted net assets (such as board-designated endowments) in the notes to the financial statements or on their face, provided that total unrestricted net assets are displayed.

Following are a few illustrative examples of net assets disclosures:

Note X: Analysis of Restricted Net Assets

Restricted net assets consisted of the following restricted amounts as of September 30, 20X2:

	Temporarily Restricted	*Permanently Restricted*
Acquisition of art	$ 10,942,210	$ 56,170,104
Center for Advanced Study in the Visual Arts	918,220	11,579,168
Special exhibitions	7,077,392	744,000
Investment in fixed assets	85,555,854	—
Sculpture garden and other capital projects	6,586,896	—
Research	42,886	1,505,000
Conservation	32,798	5,650,000
Operations	780,577	69,902,300
Publications, including catalogues	870,440	—
	$112,807,273	$145,550,572

Note X: Net Assets Released From Restrictions

Net assets were released from donor restrictions when expenses were incurred to satisfy the restricted purposes specified by donors for the year ended September 30, 20X2, as follows:

	Operating	*Nonoperating*
Acquisition of art		$ 5,775,407
Center for Advanced Study in the Visual Arts	815,490	—
Special exhibitions	7,185,307	—
Depreciation of building and capital improvements	—	2,693,880
Capital projects	—	4,309,407
Research	55,604	—
Conservation	359,191	—
Operations	779,544	—
Publications, including catalogues	—	368,390
	$9,195,136	$13,147,084

Note X: Net Asset Transfers
During the year ended May 31, 20X2, net assets were transferred to permanently restricted net assets from temporarily restricted net assets as a result of a donor's request that the Organization provide matching funds for a newly created endowment.

Auditing Considerations

Since net assets cannot be measured independently of an organization's assets and liabilities, the auditor's consideration of net asset balances generally focuses on the assertions about rights and obligations and presentation and disclosure.

Financial Statement Assertions About Rights and Obligations. To determine that net assets are used and accounted for in accordance with donor restrictions and management has controls in place that monitor compliance with donor restrictions, auditors should consider reviewing the minutes of the governing board committee meetings, gift agreements, and solicitation materials for evidence of donor restrictions. Furthermore, to determine compliance with donor restrictions, auditors should also test expenditures to determine that restricted net assets are used for their intended purposes.

Financial Statement Assertions About Presentation and Disclosure. To determine that temporarily restricted net assets are reclassified as unrestricted net assets in the statement of activities when donor-imposed restrictions have been fulfilled and that controls have been put in place to make sure that reclassification of temporarily restricted net assets occurs when donor-imposed restrictions have been fulfilled, auditors should consider determining that appropriate reclassifications have been made on the statement of activities when donor-imposed restrictions have been fulfilled by checking whether expense transactions selected for testing are for purposes for which restricted net assets are available and inspecting the supporting documentation that shows that a corresponding amount of temporary restrictions were released. As set forth in FASB Statement No. 117, an expiration of donor-imposed restrictions that simultaneously increase one class of net assets and decrease another (reclassifications) should be reported as separate items.

As for board designated assets, the auditor should examine the documentation available, such as the board minutes to verify approvals to support that the movement within a net asset class for the designation is appropriate.

Accounting for PPE and Inventory Received as Gifts-in-Kind

As discussed earlier, there has been a surge in the volume of gifts-in-kind by corporations looking to positively affect their communities. Businesses, corporations, and individual donors make these types of contributions of goods that are of value to a not-for-profit organization. These noncash contributions can take various forms, such as gifts of long-lived assets, gifts of inventory, gifts of items used for fund-raising purposes, or gifts of supplies and other materials. Here the primary focus will be on not-for-profits that receive gifts-in-kind assets such as property, equipment, materials, and inventory.

Recognition and Measurement Requirements

Generally, noncash contributions that can be used or sold are measured at fair value and recognized as contributions when received or promised. Gifts-in-kind that have no value should not be recognized. As discussed in paragraph 84 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, examples of items that often have no value or have highly restricted alternative uses include contributions of flora, fauna, photographs, and objects that are identified with historic persons, places, or events.

Determining Fair Value

In determining fair value, organizations should consider the quality and quantity of the gifts, as well as any applicable discounts that would have been received by the organization, including discounts based on that quantity if the assets had been acquired in exchange transactions. The NPO Guide states that estimates of fair value may be obtained from published catalogs, vendors, independent appraisals, estimated selling prices, and other sources. If methods, such as estimates, averages, or computational approximations, such as average value per pound or subsequent sales, can reduce the cost of measuring the fair value of inventory, use of those methods is appropriate, provided the methods are applied consistently, and the results of applying those methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be (1) used internally by the not-for-profit organization or for program purposes or (2) sold by the organization, the item received should not be recognized.

Also, FASB Statement No. 116 states that quoted market prices, if available, are the best evidence of the fair value of nonmonetary assets. If quoted market prices are not available, fair value may be estimated based on quoted market prices for similar assets, independent appraisals, or valuation techniques, such as the present value of estimated future cash flows.

If a not-for-profit organization decides not to record a material noncash contribution merely because the fair value of a noncash contribution is challenging to determine, the auditor would consider modifying the audit report due to the departure from GAAP.

Contributed Inventory

Not-for-profit organizations may acquire merchandise inventory for resale, for example, items held for sale by a bookstore, dining service, kitchen, or thrift shop. Merchandise inventory may be acquired by not-for-profit organizations from contributions. Contributions of inventory should be reported in the period received and should be measured at fair value.

FASB Statement No. 116 states that disclosures about contributions are not a satisfactory substitute for financial statement recognition. Accordingly, if not-for-profit organizations disclose information about certain noncash contributions in the notes to financial statements but have not recognized those gifts as revenues, the organization is not in compliance with FASB Statement No. 116, which states that nonrecognition or delayed recognition generally omits relevant information about an entity's economic resources and obligations and about its activities during a period, making financial statements unnecessarily incomplete. Furthermore, information about gifts-in-kind transactions may be required to be disclosed under FASB Statement No. 57, *Related Party Disclosures.*

Measurement of Alternative Investments

Some not-for-profits report certain investments at fair value in conformity with Appendix A, "Measuring Other Investments," of Chapter 8 of the NPO Guide. Recent information suggests that some not-for-profits may be improperly measuring investments purported to be reported at fair value. For example, some not-for-profits believe they are reporting investments at fair value but may instead be using valuations provided by third parties, such as trustees or perhaps fund mangers, that do not represent fair value in conformity with GAAP. See the discussion on the proposed auditing Interpretation, "Auditing the Fair Value of Investments Held by Trustees," in the Auditing Pipeline—Nonpublic Companies" section of the Alert. The draft of the Interpretation states that management has the primary responsibility for determining fair value.

On a related issue, some not-for-profits are entering into hedge funds as alternative investment strategies to improve their investment returns. Because the performance of hedge funds is not highly correlated with the broad securities market, such as stocks and bonds with readily determinable fair value, they offer the possibility of low volatility and high returns. Auditors of not-for-profits with significant investments in hedge funds should carefully consider the not-for-profit's exposure to risk. For instance, the auditor may consider risks associated with (1) whether the not-for-profit is acting as a prudent investor in compliance with donor stipulations and relevant laws, (2) the valuations of those hedge funds, and (3) potential effects on the organization's ability to continue as a going concern. Although hedge funds apparently have generated sizable investment returns over the last year or two, there is no guarantee those rates of return will continue.

Accounting for Fund-Raising Costs

A December 2004 study, “Nonprofit Fund-raising and Administrative Cost,” a joint effort by the Center on Philanthropy at Indiana University and the Center on Nonprofits and Philanthropy at the Urban Institute in Washington D.C., concludes that many not-for-profits are neglecting to report expenses associated with fund-raising or special events. The study ascertained that 37 percent of nonprofits with private contributions of $50,000 or more in the year 2000 reported no fund-raising or special event costs. This included more than 18 percent of organizations raising $5 million or more that reported no such costs. The case studies and survey data suggested the following reasons for not reporting fund-raising costs: pervasive problems stemming from weak accounting and management infrastructure, a misunderstanding of accounting rules, and a structure of incentives that promotes poor reporting.

Readers are reminded that fund-raising costs are those incurred to persuade potential donors to make contributions to an organization. Such costs should be expensed as incurred, meaning when the item or service has been received.

Furthermore, fund-raising costs incurred in one period—such as those made to obtain bequests, compile a mailing list of prospective donors, or solicit donations in a direct response activity—may result in contributions that may be received in future periods. Nevertheless, those fund-raising costs should be expensed as incurred.

Readers may obtain a copy of the study at nccsdataweb.urban.org/FAQ/index.php?category=40.

FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*

FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*, clarifies that the term *conditional asset retirement obligation* as used in FASB Statement No. 143, *Accounting for Asset Retire-*

ment Obligations, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. Uncertainty about the timing and/or method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. FASB Interpretation No. 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation.

FASB Interpretation No. 47 includes two examples of factories that are contaminated with asbestos. In both examples, an unconditional obligation to remove the asbestos at some future date exists, because no building lasts forever. The entity would not recognize a liability at the date it acquired the factory, however, because the entity's acquisition of the factory created an unconditional obligation to perform the asset retirement activity (obligating event), the entity does not have sufficient information to reasonably estimate the fair value of the asset retirement obligation. Because the asset retirement obligation is not recognized, the entities in the examples would disclose (1) a description of the obligation, (2) the fact that a liability has not been recognized because the fair value cannot be reasonably estimated, and (3) the reasons why fair value cannot be reasonably estimated. In some circumstances, sufficient information to estimate the fair value of the asset retirement obligation becomes available in subsequent periods. The entity should recognize an asset retirement obligation if and when the entity has sufficient information to estimate the fair value of the asset retirement obligation.

FASB Interpretation No. 47 is effective no later than the end of the fiscal year ending after December 15, 2005. Early adoption of the Interpretation is encouraged. Readers should be aware that this Interpretation may have significant implications for some not-for-profits, for example, dormitories at colleges and universities.

The Gift of Real Estate

A medley of giving options is available today. In addition to cash, a donor may gift real estate or any one of various investment vehicles to not-for-profits. Even though such gifts may be of enormous benefit, the legal complexity of receiving and liquidating them can be challenging. Not-for-profits may need the expertise of brokers, appraisers, and tax experts when accepting real estate to maximize the gift's value. Additionally, not-for-profits may face environmental problems and complications with the real estate titles.

Donors may use a variety of avenues in gifting real estate. For example, it may be given as an outright gift, which is the simplest transaction since the donor transfers title immediately to the charity. Or it may be given as commercial property that may generate rental income and has no mortgage. It may also be given as a deferred gift where the donor makes an irrevocable gift to a charitable remainder unitrust or annuity trust. Moreover, it can be given by bequest.

Generally, not-for-profits account for investments in real estate by using the guidance provided in NPO Guide Chapter 8, paragraph 8.03, and Appendix A; the guidance there states that investments not covered by FASB Statement No. 124 or FASB Statement No. 133, as amended, are referred to in the NPO Guide as *other investments*. Some exceptions may be where not-for-profits report investments in real estate under SOP 78-9, *Accounting for Investments in Real Estate Ventures*, as well as those reporting under SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, and perhaps under the equity method under Emerging Issues Task Force (EITF) Issue No. 03-16, "Accounting for Investments in Limited Liability Companies." Auditors should also refer to paragraph 9.10 in the NPO Guide regarding long-lived assets held for sale if the organization decides not to hold the real estate as an investment. Other investments include, among others, investments in real estate, mortgage notes, venture capital funds, partnership interests, oil and gas interests, and equity securities that do not have a readily determinable fair value.

TPA on Guarantees of Employee Loans

The AICPA recently issued a healthcare Technical Practice Aid (TPA), section 6400.46, "Applicability of FASB Interpretation No. 45—Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—Mortgage Guarantees," regarding the application of FASB Interpretation No. 45 to physician loans. The TPA concludes that guarantees of loans for physicians that are employees are not subject to the requirements of FASB Interpretation No. 45. Not-for-profits should be aware that this TPA is applicable to any guarantee of a loan to an employee. Thus, a guarantee of an employee's loan is not subject to FASB Interpretation No. 45 and a liability for the guarantee does not need to be reported in the statement of financial position. For a more detailed discussion, readers should refer to the TPA at www.aicpa.org/download/acctstd/TPA_6400_46.pdf.

EITF Issues for Consideration

Some practitioners may fail to consider FASB EITF consensus opinions when working on not-for-profit engagements; however, EITF consensus opinions that do not conflict with guidance at levels (a) and (b) of GAAP are applicable to not-for-profit organizations. Therefore, we present these EITF Issues for consideration on your engagements. Readers should be aware that the guidance in EITF Issues No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," and No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock," should be considered in conjunction with the guidance brought forward from the superseded Guides (paragraphs A.8 through A.10 included in Appendix A of Chapter 8 in the NPO Guide) and the guidance in AICPA SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations.* (NPO Guide Chapter 8, Appendix B, paragraph 8.35). Thus, those consensus opinions do not apply to investments that are held in portfolios that are reported at current market value or fair value. However, those consensus opinions should be considered if other investments are reported at cost or lower of cost or market/fair value.

EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"

On September 30, 2004, the FASB staff issued FASB Staff Position EITF 03-1-1, *Effective Date of Paragraphs 10–20 of EITF Issue No. 03-1*, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, (FSP 03-1-1). The FSP delays the effective date for the measurement and recognition guidance contained in paragraphs 10 through 20 of EITF Issue No. 03-1 until the final issuance of FASB Staff Position EITF Issue 03-1-a. Readers should be alert to its issuance. The disclosure guidance in paragraphs 21 and 22 of EITF Issue No. 03-1 remains effective. The disclosure requirements are described in paragraphs A.2 to A.6 of the NPO Guide (2005 edition). Alternatively, they can be found at www.fasb.org/eitf/03_17-18_04_mtg_minutes.pdf.

EITF Issue No. 03-13, "Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations"

EITF Issue No. 03-13 provides guidance for determining whether transactions of components that have been disposed of or are held for sale should be reported in a separate section of the statement of activities entitled "discontinued operations." The draft abstract of the consensus opinion can be found at www.fasb.org/eitf/11_17-18_04_mtg_minutes.pdf.

EITF Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock"

The consensus opinion reached in EITF Issue No. 02-14 provides the following guidance that for purposes of applying Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The term *common stock* includes "in-substance common stock" (as defined under EITF Issue No. 02-14). Therefore, an organization that has the ability to exercise significant influence over the operating and financial policies of the for-profit entity should apply the guidance under EITF Issue 02-14 only when it has an investment(s) in common stock and/or an investment that is in-substance common stock.

In-substance common stock is an investment in a for-profit investee that has risk and reward characteristics that are substantially similar to that entity's common stock. It might be an investment in a different class of stock or in an in-the-money warrant or option. EITF Issue No. 02-14 provides numerous factors to consider when determining whether an investment is in-substance common stock. It also provides examples that illustrate the application of the characteristics to various investments.

If the organization holds investments in *equity securities* that are accounted for under the equity method of accounting, but those investments are not common stock or in-substance common stock, the equity method of accounting should be discontinued on the effective date of EITF Issue No. 02-14. Previously recognized equity method earnings and losses should not be reversed. This requirement does not change the accounting for beneficial interests in trusts as required by FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*. The consensus opinion does not apply to investments accounted for under FASB Statement No. 133, noncorporate entities accounted for under AICPA SOP 78-9, *Accounting for Investments in Real Estate Ventures*, or to LLCs accounted for under EITF Issue No. 03-16.

The consensuses in this Issue should be applied in reporting periods beginning after September 15, 2004. The draft abstract of the consensus opinion can be found at www.fasb.org/eitf/june_july_2004_mtg_minutes.pdf.

FASB Staff Position That May Be Applicable to Not-for-Profits

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) was signed into law on December 8, 2003. The most publicized aspect of this legislation is the prescription drug benefit. The FASB issued FSP 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription*

Drug, Improvement and Modernization Act of 2003, to provide guidance on the accounting for the effects of the Act for employers that sponsor postretirement heath care plans that provide prescription drug benefits. The FSP also requires those employers to provide certain disclosures regarding the effect of the federal subsidy provided by the Act. Readers should refer to the FASB Web site at www.fasb.org/fasb_staff_positions/fsp_fas106-2.pdf for further information on this FSP, including the scope and effective date.

Recent Auditing, Attestation, and Quality Control Pronouncements and Related Guidance

Presented below is a list of auditing, attestation, quality control, and related guidance issued since the publication of last year's Alert. For information on auditing and attestation standards, quality control standards, and related guidance that may have been issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm.

You may also look for announcements of newly issued standards in *The CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA's Audit and Attest Standards team and available at www.aicpa.org/members/div/auditstd/opinion/index.htm.

SOP 04-1 (November 2004) (Not applicable to audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards)	*Auditing the Statement of Social Insurance* This SOP assists CPAs in auditing the statement of social insurance—a financial statement required by Federal Accounting Standards Advisory Board (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) No. 17, *Accounting for Social Insurance*, and SFFAS No. 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*.
Auditing Interpretation No. 1 of SAS No. 50 (January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Requirement to Consult With the Continuing Accountant" (AICPA, *Professional Standards,* vol. 1, AU sec. 9625.01)

Auditing Interpretation No. 15 of SAS No. 62 (January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.96)
Auditing Interpretation No. 14 of SAS No. 62 (amended: January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.90)
Auditing Interpretation No. 12 of SAS No. 62 (amended: January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, *Professional Standards,* vol. 1, AU sec. 9623.60)
Auditing Interpretation No. 17 of SAS No. 58 (June 2004) (Not applicable to audits conducted in accordance with PCAOB standards)	"Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.85) This Interpretation provides illustrative language in the auditor's report to clarify that an audit performed in accordance with generally accepted auditing standards (GAAS) does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer for whom Section 404(b) of the Sarbanes-Oxley Act of 2002 is applicable.
Auditing Interpretation No. 18 of SAS No. 58 (June 2004) (Not applicable to audits conducted in accordance with *only* PCAOB standards)	"Reference to PCAOB Standards in an Audit Report of a Nonissuer" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.89) This Interpretation clarifies the applicability of GAAS and provides illustrative language for a dual reference reporting situation when the audit was conducted in accordance with both GAAS and the auditing standards of the PCAOB.
Interpretation No. 6 of Chapter 1, "Attest	"Reporting on Attestation Engagements Performed in Accordance With Government

(*continued*)

Engagements,"of Statement on Standards for Attestation Engagements (SSAE) No. 10, as amended. (December 2004)	Auditing Standards" (AICPA, *Professional Standards*, vol. 1, AT sec. 101.56)
AICPA Toolkit (December 2003) (nonauthoritative)	*The AICPA Audit Committee Toolkit* This toolkit provides comprehensive advice on audit committee duties such as agenda setting, conducting executive sessions, and evaluating the effectiveness of auditors and the audit committee itself. It also offers basic information on important topics such as internal controls, antifraud accountability, and off-balance-sheet transactions.
AICPA Practice Alert 2004-1 (October 2004) (nonauthoritative)	*Illegal Acts* This Practice Alert is intended to guide the auditors of nonissuers with respect to illegal acts.
AICPA Audit and Accounting Practice Aid (November 2004) (nonauthoritative)	*Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* This Practice Aid can help practitioners better understand and apply the Statements on Quality Control Standards issued by the AICPA. It contains new policies and procedures that a firm should consider including in its system of quality control to be responsive to the changing environment.
New Committee of Sponsoring Organizations (COSO) Framework	*Enterprise Risk Management—Integrated Framework* This document describes the essential components, principles, and concepts of enterprise risk management for all organizations, regardless of size. With heightened concern and focus on risk management, the framework provides boards of directors and managements with a clear roadmap for identifying risks, avoiding pitfalls, and seizing opportunities to grow stakeholder value. This new framework is expected to be widely accepted as the benchmark for dealing with business risk. The framework can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com/store.

As necessary, auditors should obtain and understand the complete text of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

Auditing Standards Available on AICPA Web Site

The standards and interpretations promulgated by the AICPA Auditing Standards Board (ASB) are now available free of charge by visiting the AICPA Audit and Attest Standards Team's page at www.aicpa.org/members/div/auditstd/Auth_Lit_for_NonIssuers.htm. Members and nonmembers alike can download the auditing, attestation, and quality control standards by either choosing a section of the codification or an individual statement number. You can also obtain copies of AICPA standards and other guidance by contacting the AICPA at (888) 777-7077 or online at www.cpa2biz.com.

Recent AICPA Independence and Ethics Pronouncements

The AICPA *Independence and Ethics Alert—2004/05* (product no. 022475kk) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain that Alert to be aware of independence and ethics matters that will affect their practice. In addition to the other matters discussed in I*ndependence and Ethics Alert—2004/05*, auditors should be aware of these recent issuances by the AICPA Professional Ethics Executive Committee:

- *Revised AICPA Ethics Interpretation No. 101-3*, "Performance of Nonattest Services." This revised Interpretation modifies the practitioner's responsibilities for maintaining independence when providing nonattest services (for example, tax or consulting services) to attest clients.
- *AICPA Members Who Outsource*. Ethics Ruling No. 112, "Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.224-.225), and Ethics Ruling No. 12, "Applicability of General and Technical Standards When Using a Third-Party Service Provider," of ET section 291, *Ethics Rulings on General and Technical Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 291.023-.024). These rulings provide new

requirements related to members who outsource certain professional services.

Recent Accounting Pronouncements and Related Guidance

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in *The CPA Letter* and *Journal of Accountancy.*

FASB Statement No. 154 (May 2005)	*Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3* This Statement replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed.
FASB Statement No. 123 (revised December 2004)	*Share-Based Payment* This Statement is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. This Statement supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. It establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services and also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.
FASB Statement No. 153 (December 2004)	*Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* This Statement amends APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, to eliminate

	the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange.
FASB Statement No. 152 (December 2004)	*Accounting for Real Estate Time-Sharing Transactions, an amendment of FASB Statements No. 66 and 67* This Statement amends FASB Statement No. 66, *Accounting for Sales of Real Estate*, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions*. This Statement also amends FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to state that the guidance for (1) incidental operations and (2) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2.
FASB Statement No. 151 (November 2004)	*Inventory Costs, an amendment of ARB No. 43, Chapter 4* This Statement clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities.
FASB Interpretation No. 47 (March 2005)	*Accounting for Conditional Asset Retirement Obligations*
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs. Some of the recently issued FSPs address issues relating to FASB Statements No. 19, No. 106, No. 109, No. 129, No. 140, No. 141, No. 142, No. 144, No. 146, and No. 150, among others, as well as, FASB Interpretations No. 45 and No. 46(R), and EITF Issue No. 03-1.
SOP 04-2 (December 2004)	*Accounting for Real Estate Time-Sharing Transactions*
AICPA Audit and Accounting Practice Aid (May 2004) (nonauthoritative)	*Valuation of Privately Held Company Equity Securities Issued as Compensation* This Practice Aid provides useful information on measuring the cost of such transactions and properly reflecting them in company financial statements.

The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information. You can obtain copies of AICPA standards and other guidance by contacting the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. You should check the appropriate standard-setting Web sites (listed below) for a complete picture of all accounting and auditing projects in progress. Presented below is brief information about some ongoing projects that are especially relevant to the not-for-profit industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or generally accepted auditing standards (GAAS).

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

Standard-Setting Body	*Web site*
AICPA Auditing Standards Board (ASB) (Note that for audits of public companies, the PCAOB sets auditing standards.)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org
Governmental Accounting Standards Board (GASB)	www.gasb.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to service@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Overhaul Project—AICPA Audit and Accounting Guide *Not-for-Profit Organizations*

The AICPA is currently in the beginning stages of overhauling the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since the NPO Guide was originally issued in 1996. During that period, the AICPA will continue to issue annual editions of the NPO Guide, updated to reflect recent pronouncements.

Auditing Pipeline—Nonpublic Companies

The proposed standards discussed in this section would not apply to the audits of public companies and other audits conducted under the standards of the PCAOB. Readers should keep abreast of the status of the following projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Auditing Interpretations Pertaining to Auditing the Fair Value of Investments Held by Trustees

Currently, the ASB's Audit Issues Task Force is working on two proposed auditing Interpretations on auditing investments reported at fair value and held by a third-party trustee, as well as related proposed changes to Chapters 6 and 8 of the NPO Guide. The first proposed auditing Interpretation would provide guidance when auditing the fair value of interests in trusts held by a third-party trustee in circumstances in which the fair value of the interest in the trust is estimated using the fair value of investments for which a readily determinable fair value does not exist. The second auditing Interpretation would provide guidance when auditing investments are made with a third party in circumstances in which a readily determinable fair value does not exist. The point of the Interpretations is to clarify that a confirmation from someone holding the investment (asset) is not sufficient audit evidence when auditing the valuation assertion. Readers should be alert to the issuance of these auditing Interpretations by the Audit Issues Task Force in the near future.

Eight SASs Related to Audit Risk Proposed

In April 2005 the AICPA's ASB voted to expose eight new and/or amended SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit.

These proposed SASs were originally exposed on December 2, 2002 (except for the amendment to SAS No. 1 which was approved for exposure by the ASB on April 28, 2005). As a result of significant revisions made to the original exposure draft, the ASB concluded that the exposure drafts should be re-exposed for comment. The significant revisions made were as follows:

1. Changes resulting from the comment letters received to the original exposure draft
2. Revisions made by the International Auditing and Assurance Standards Board (IAASB) in finalizing their risk assessment International Statements on Auditing (ISA) exposure drafts.
3. Changes arising from the issuance by the PCAOB of *Conforming Amendments to PCAOB Interim Standards Resulting from Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.*

The Exposure Draft of the Eight Proposed Statements on Auditing Standards Related to Risk Assessment can be found at http://www.aicpa.org/members/div/auditstd/2005_06_15_risk_assess_2.htm.

Proposed SAS, *Defining Professional Requirements in Statements on Auditing Standards*, and a Proposed SSAE, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*

These proposed Statements establish and define terminology the ASB will use to describe the varying degrees of responsibility that the requirements impose on an auditor or practitioner.

Proposed SAS, *Audit Documentation*

The proposed Statement will supersede SAS No. 96 of the same name (AICPA, *Professional Standards*, vol. 1, AU sec. 339).

This proposed SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation for audits of financial statements or other financial information being reported on.

Proposed SAS, *Communication of Internal Control Related Matters Noted in an Audit*

This proposed SAS will supercede SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended, and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies.

Proposed SSAE, *Reporting on an Entity's Internal Control Over Financial Reporting* (AT sec. 501)

This proposed Statement will establish standards and provide guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting (or on an assertion thereon).

As potential users of SSAE No. 10 (AT sec. 501) reports, the nonprofit community should be alert for the issuance of a final standard in early 2006.

Proposed SSARS, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement and Pro Forma Financial Information*

The proposed statement would amend SSARS No. 1, *Compilation and Review of Financial Statements* (AR sec. 100), to enable an accountant to compile elements, accounts, or items of a financial statement, and pro forma financial information.

Proposed SSARS, *Restricting the Use of an Accountant's Compilation or Review Report*

The proposed Statement provides guidance to accountants on restricting the use of reports issued pursuant to SSARS. The proposed Statement:

- Defines the terms *general use* and *restricted use*.

- Describes the circumstances in which the use of an accountant's report should be restricted.
- Specifies the language to be used in accountants' reports that are restricted as to use.

The proposed SSARS would be effective upon issuance.

Omnibus Statement on Standards for Accounting and Review Services—2005

The proposed Statement would amend:

- SSARS No. 1 to require the accountant to communicate to the appropriate level of management, information that comes to his or her attention that leads the accountant to believe fraud may exist.
- SSARS No. 2, *Reporting on Comparative Financial Statements* (AR sec. 200), to enable a successor accountant to compile or review a restatement adjustment when prior-period financial statements have been changed.
- SSARS No. 1 to provide guidance regarding matters that should cause the accountant to consider obtaining an updated representation letter from management.

This proposed Statement would be effective for compilations and reviews of financial statements for periods ending on or after December 15, 2005.

Accounting Pipeline

Proposed FASB Statement *Qualifying Special-Purpose Entities and Isolation of Transferred Assets—an amendment of FASB Statement No. 140*

This proposed Statement would amend and clarify FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in several ways. The initial exposure draft for this proposed Statement was issued in June 2003. However, in response to several comment letters, the FASB began redeliberations on the issues raised. Readers should be alert for the issuance of a revised exposure draft, which is expected to occur in the third quarter of 2005. The FASB will be issuing two additional exposure drafts pertaining to FASB Statement No. 140 also in the third quarter of 2005. The exposure drafts will pertain to beneficial interests in securitized financial assets and servicing rights. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement *Fair Value Measurements*

In June 2004, the FASB published an exposure draft of a proposed Statement, *Fair Value Measurements*, which seeks to establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of the measurements. The fair value framework would clarify the fair value measurement objective and its application under authoritative pronouncements that require fair value measurements. The exposure draft would replace any current guidance for measuring fair value in those pronouncements and would expand current disclosures. Readers should be alert for the issuance of a final Statement, which is expected to occur in the third quarter of 2005. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement *GAAP Hierarchy*

On April 28, 2005, the FASB issued an exposure draft of a proposed FASB Statement, *The Hierarchy of Generally Accepted Accounting Principles*, which would supersede the hierarchy currently presented in AICPA SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as amended. The proposed Standard would carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. Those modifications are (1) to carry forward the categorization of the sources of accounting principles by document type as presented in paragraph .10 of SAS No. 69, and not by their characteristics as presented in paragraph .05 of SAS No. 69, and (2) to expand the sources of category (*a*) to include FASB Staff Positions and FASB Statement No. 133 Implementation Issues. The proposed Standard would be effective for fiscal periods beginning after September 15, 2005. Readers should be alert to the issuance of a final Standard.

Exposure Draft of a Statement of Position (SOP), ***Clarification of the Scope of the Audit and Accounting Guide*** **Audits of Investment Companies** ***and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies***

The proposed SOP (referred to hereafter as the Investment Companies Guide SCOPE SOP) provides specific conditions for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Audits of Investment Companies* (the Guide). For those entities that are investment companies under the Investment Companies Guide SCOPE SOP, the SOP also addresses the retention of the specialized industry accounting for investment companies by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity (referred to as an equity method investor).

Readers should be alert to the fact that the Investment Companies Guide SCOPE SOP would reconcile and conforms SOP 94–3, *Reporting of Related Entities by Not-for-Profit Organizations*, and the AICPA Audit and Accounting Guide *Health Care Organizations* (Health Care Guide) to clarify that not-for-profit organizations, including not-for-profit health care organizations, that are parent companies of or equity method investors in for-profit entities that apply investment company accounting pursuant to the Investment Companies Guide SCOPE SOP should consider whether investment company accounting should be retained in the financial statements of the not-for-profit organization parent company or equity method investor pursuant to the Investment Companies Guide SCOPE SOP.

Specifically, for those entities that are investment companies under the Investment Companies Guide SCOPE SOP, the Investment Companies Guide SCOPE SOP also addresses the retention of that specialized industry accounting by a parent company in consolidation. For example, not-for-profit organizations with a controlling financial interest in a for-profit entity, through direct or indirect ownership of a majority voting interest in that entity, that apply investment company accounting pursuant to the Investment Companies Guide SCOPE SOP should consider whether investment company accounting should be retained in the financial statements of the parent not-for-profit organization pursuant to the Investment Companies Guide SCOPE SOP.

Also, for those entities that are investment companies under the Investment Companies Guide SCOPE SOP, the SOP also addresses the retention of that specialized industry accounting by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity. For example, not-for-profit organizations with investments in common stock of a for-profit entity that applies investment company accounting pursuant to the SOP, wherein the not-for-profit organization's investment qualifies for the equity method in conformity with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, should consider whether investment company accounting should be retained in the financial statements of the investor not-for-profit organization pursuant to the Investment Companies Guide SCOPE SOP.

Furthermore, Chapter 8 of the NPO Guide permits investment portfolios to be reported at fair value in certain circumstances. Not-for-profit organizations that report investment portfolios at fair value in conformity with the NPO Guide would be permitted to continue to do so.

Readers should be alert to the final issuance of the Investment Companies Guide SCOPE SOP.

Combinations of Not-for-Profit Organizations

In November 1999, the FASB affirmed its earlier decision to undertake a project on combinations of not-for-profits that is separate from its business combinations project. As a result of that decision, combinations of not-for-profits are excluded from the scope of FASB Statement No. 141, *Business Combinations*. The FASB also agreed to delay the effective date of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, as it applies to combinations of not-for-profits, until the FASB addresses the issues related to such combinations.

The objective of this project is to develop guidance on the accounting and reporting for combinations of not-for-profits. As of the January 26, 2005 meeting, the FASB completed its deliberations related to the following issues:

- The method of accounting for combinations of not-for-profits
- The criteria to be used to identify the acquiring not-for-profit
- Recognition of goodwill subsequent to acquisition
- Recognition of goodwill at date of acquisition
- The disclosures required by not-for-profits
- The effective date and transition method to be applied by not-for-profits
- Change in the nature of a reporting unit's primary support
- Assigning assets, liabilities, and goodwill to reporting units
- Reorganization of reporting structure

For a tentative summary of the decisions reached by the FASB so far on the combinations of not-for-profit organizations, go to www.fasb.org and look at project updates. An exposure draft is planned for the third quarter of 2005. Readers should be alert for the issuance of a final Statement.

AICPA Audit and Accounting Products and Services

AICPA

Web Site

AICPA Online (www.aicpa.org) is the AICPA's Web site on the Internet. The site offers users the opportunity to stay abreast of developments in accounting and auditing. Online resources include professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, exposure drafts, and a list of links to other accounting- and finance-related sites. The AICPA Web site also features a "Talk to Us" section, allowing users to send e-mail messages directly to AICPA representatives or teams. The AICPA Web site includes a separate section that deals with Circular A-133 audit issues, including a document that provides unofficial answers to frequently asked questions, at www.aicpa.org/belt/a133main.htm.

Order Department (Service Center Operations)

To order AICPA products, call the AICPA Member Service Center at (888) 777-7077 or fax to (800) 362-5066. The best times to call are 8:30 a.m. to 11:30 a.m. and 2:00 p.m. to 7:30 p.m., Eastern Standard Time. Also, visit the CPA2Biz Web site at www.cpa2biz.com to obtain product information and place online orders.

Industry Conference

The AICPA National Governmental and Not-for-Profit Training Program will be held on October 17-19, 2005, in New Orleans, and the AICPA Not-for-Profit Financial Executive Forum on November 16–18, 2005, in San Francisco. For further information, call the AICPA CPE Conference Hotline at (888) 777-7077 or for a detailed brochure, log onto www.cpa2biz.com/conferences.

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

The AICPA Professional Ethics Team answers inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

New AICPA Audit Quality Centers Established

Governmental Audit Quality Center

In September 2004, the AICPA launched the Governmental Audit Quality Center, which is designed to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The Center is a voluntary membership center that will give CPA firms the tools they need to adhere to a high standard of quality in conducting governmental audits, including audits of federal, state, and local governments; not-for-profit organizations; and certain for-profit organizations. It will also be a place where firms dedicated to quality governmental audits will share best practices, learn about emerging issues, and take steps to enhance quality in their practices. For more information or to join, visit www.aicpa.org/gaqc.

Employee Benefit Plan Audit Quality Center

Created in March 2004, the AICPA Employee Benefit Plan Audit Quality Center is intended to provide a forum that spurs CPA firms performing audits to make immediate quality improvements to employee benefit audits under the Employee Retirement Income Security Act of 1974 (ERISA), including pension, health and welfare, and 401(k) plans. In addition to gaining access to best practices, guidelines, and tools focused around quality improvement, members of the Center will be subject to membership requirements that demonstrate the firm's commitment to audit quality in this area. Additional information about the Center can be found at www.aicpa.org/ebpaqc.

Continuing Professional Education Courses

The AICPA offers many continuing professional education (CPE) courses related to not-for-profits, many of them available for both group study and self-study. Among the available titles are the following:

- Accounting and Reporting Practices of Not-for-Profit Organizations (product no. 743273kk)

- Form 990: AICPA's Answer to Unlocking the Tax Complexities (product no. 731057kk)
- Clever Cases on Current Complexities Confronting Governments & Not-for-Profits (product no. 731911kk)
- Religious Organizations: Key Accounting, Tax, and Financial Issues (product no. 732561kk)
- Governmental & Nonprofit Annual Update (2005–2006 Edition) (product no. 731932kk)
- 2004-2005 Not-For-Profit Organizations "Specialized Industry Briefing" (product no. 780009hskk)
- Fraud in the Governmental and Not-For-Profit Environments: What a Steal! (product no. 731921kk)
- Advanced Accounting and Auditing Problems for NPOs (product no. 731121kk)
- Advanced Auditing of HUD-Assisted Projects (product no. 730191kk)
- Applying A-133 to Nonprofit and Governmental Organizations (product no. 730206kk)
- Audits of HUD-Assisted Projects (product no. 730296kk)
- Analytical Procedures for Nonprofit Organizations (product no. 730220kk)
- Cost Allocation in Nonprofits: Who Gets It? (product no. 730414kk)
- Managing Nonprofit Organizations Like a Business (product no. 730343kk)
- Nonprofit Auditing and Accounting Update (2005–2006 Edition) (available in text [product no. 732091kk] and video [product no. 182070kk])
- Auditing Nonprofits: Tips and Traps (product no. 731522kk)
- Private Foundations: Mastering the Unique Tax Aspects (product no. 732271kk)

- Solving Complex Single Audit Issues for Government and Nonprofit Organizations (product no. 734409kk)
- Nonprofit Organizations: Guide to Advanced Tax Planning (product no. 736767kk)
- Using the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*
- Workpaper Techniques for Government and Nonprofit Organizations (product no. 732634kk)
- The Revised Yellow Book: Government Auditing Standards (product no. 736114kk)
- Using Competition for Performance Improvement: A Resource for Practitioners Advising Governments and Not-for-Profits (product no. 056507kk)

For more information about AICPA CPE courses, call the AICPA Member Service Center at (888) 777-7077 or visit the AICPA Web site at www.aicpa.org.

Online CPE

AICPA InfoBytes, offered exclusively through CPA2Biz.com, is the AICPA's flagship online learning product. AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

The AICPA Audit Committee Toolkit: Not-for-Profit Organizations

In response to increasing interest in not-for-profit governance, the AICPA has issued a new NPO Audit Committee Toolkit. Audit committees have a big job to do in an organization—difficult when the members have other responsibilities and the audit committee role is a part-time job with huge accountability. The AICPA Audit Committee Toolkit: Not-for-Profit Organizations is the needed help for audit committees to do the job they need to do as effectively and efficiently as possibly. Providing these tools in the public interest, the AICPA, with the generous support of our sponsors, endeavors to help audit committees, internal auditors, and the leaders of the financial management organization execute corporate governance. The toolkit contains information, checklists, and sample policies to help not-for-profit organizations improve board governance through the establishment of effective audit committees. For example, tools included in the toolkit include an audit committee charter matrix, a detailed description of the audit process, a set of expectations for internal auditors, and a description of how to conduct an executive session. Not-for-profit auditors may consider providing a copy of the toolkit to their clients. The AICPA's Not-for-Profit Audit Committee Toolkit is available at www.aicpa.org/audcommctr/homepage.htm. A professionally printed soft-cover book version of this Toolkit will be available for purchase in the fall of 2005.

Not-for-Profit Organizations Checklists

The AICPA Accounting and Auditing Publications Team publishes *Checklists and Illustrative Financial Statements for Not-for-Profit Organizations*, a nonauthoritative publication designed to help those preparing reports and financial statements of not-for-profits.

Practice Aids

Accounting Trends and Techniques—Not-for-Profit Organizations is a comprehensive Practice Aid (product no. 006616kk) that illustrates a wide variety of financial statement formats and disclosures for not-for-profits.

Fraud Detection in a GAAS Audit, Revised Edition (product no. 006615kk), is a Practice Aid that provides CPAs with the most recent information related to the implementation of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit.*

Technical Practice Aids

AICPA Technical Practice Aids includes questions received by the AICPA Technical Hotline on various subjects and the responses to those questions. TPA sections 6140 and 6960 include questions and answers specifically pertaining to not-for-profits. *Technical Practice Aids* is available both as a subscription service (product no. TPA-XXkk) and in paperback form (product no. 005145kk).

Help Desk—AICPA publications can be obtained by calling AICPA Member Service Center at (888) 777-7077 or faxing a request to (800) 362-5066.

Guidance for Audit Committees on the Risk of Fraud From Management Override of Internal Control

The AICPA Antifraud Programs and Controls Task Force has issued a document entitled *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention—The Audit Committee and Oversight of Financial Reporting*. The document offers assistance to audit committees in addressing the risk of fraud arising from management override of internal control over financial reporting. The guidance contains the following major sections:

- Management Override and the Audit Committee's Responsibilities
- Actions to Address the Risk of Management Override of Internal Controls
- Suggested Audit Committee Procedures: Strengthening Knowledge of the Business and Related Financial Statement Risks (Appendix)

The following are some of the topics related to audit committees that are covered in the document:

- Maintaining an appropriate level of skepticism.
- Strengthening the audit committee's understanding of the business.

- Brainstorming to identify fraud risks.
- Using the code of conduct to assess financial reporting culture.
- Cultivating a vigorous whistle-blower program.
- Developing a broad information and feedback network including communications with internal auditors, independent auditors, compensation committee, and key employees.

The document can be downloaded from the "Spotlight Area" on the AICPA's Audit Committee Effectiveness Center Web page at www.aicpa.org/audcommctr/homepage.htm.

References for Additional Guidance

Government Accountability Office

The Government Accountability Office (GAO) Web site at www.gao.gov contains links to the hundreds of reports and testimony to the Congress each year on a variety of subjects, including accounting, budgeting, and financial management. Printed copies of GAO reports and testimony can be obtained from the GAO, 441 G St NW, Room LM, Washington, DC 20548; phone (202) 512-6000; fax (202) 512-6061; Web www.gao.gov/cgi-bin/ordtab.pl.

The GAO's Web site also includes Comptroller General decisions and legal opinions, GAO policy documents, and special publications. You may subscribe to GAO daily electronic alerts at www.gao.gov/subtest/subscribe.html.

The following publications are available on the GAO's Web site at www.gao.gov/govaud/ybk01.htm and through the Superintendent of Documents, U.S. Government Printing Office (GPO), P.O. Box 371954, Pittsburgh, PA 15250-7954; phone (866) 512-1800 or (202) 512-1800; fax (202) 512-2250; or bookstore.gpo.gov/index.html.

- *2003 Government Auditing Standards*—These standards relate to financial and performance audits and attestation engagements of governmental organizations, programs, activities, and functions, and of governmental funds received by contractors, not-for-profit organizations, and other nongovernmental organizations. The 2003 *Government Auditing Standards* is a comprehensive revision of the 1994 version of *Government Auditing Standards* and its Amendments No. 1 through No. 3. (Note that the contents of those Amendments were incorporated into the revision.)

- *Government Auditing Standards: Answers to Independence Questions* responds to questions related to *Government Auditing Standards* independence requirements, including implementation time frame, underlying concepts, and application in specific nonaudit circumstances.

- *Interpretation of Continuing Education and Training Requirements—Government Auditing Standards* establishes specific CPE requirements for auditors working on audits performed in accordance with those standards. This Interpretation guides audit organizations and individual auditors on implementing the CPE requirements by answering the most frequently asked questions from the audit community. The GAO is expected to soon revise this Interpretation and has issued an Internet notice to amend paragraph 46 of the Interpretation.

Other Guidance

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in the AICPA general *Audit Risk Alert—2004/05* (product no. 022335kk), and AICPA *Compilation and Review Alert—2004/05* (product no. 022305kk). These Alerts may be obtained by calling AICPA Member Service Center at (888) 777-7077 or faxing a request to (800) 362-5066. Obtaining product information and placing online orders can be done at www.cpa2biz.com. (The 2005/06 versions of these publications will be issued later this year.)

Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department at (800) 748-0659.

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This Audit Risk Alert replaces *Not-for-Profit Organizations Industry Developments—2004. The Not-for-Profit Organizations Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would be appreciated. You may e-mail these comments to lwest@aicpa.org or write to:

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APPENDIX
Useful Internet Web Sites

If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to industry statistics, resources for not-for-profit organizations (NPOs) and their finance professionals, professional news, state CPA society information, IRS information, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but they are available at any time, often free of charge.

A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to:

- Obtain audit and accounting research information
- Obtain texts, such as audit programs
- Discuss audit issues with peers
- Communicate with audit clients
- Obtain information from a client's Web site
- Obtain information on professional associations

There are caveats to keep in mind when using the Internet. Reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; caution is advised when accessing data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn to use search engines effectively to minimize the amount of time browsing through useless information. The Internet is best used in tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

The following listing summarizes the various Web sites of many of the organizations referred to in this Audit Risk Alert, as well as others that auditors of not-for-profits may find useful.

Name of Site	*Content*	*Internet Address*
American Institute of CPAs	Information for CPAs on accounting, auditing, industry activities, the activities of the AICPA, and other matters	www.aicpa.org
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
Action Without Borders	Includes a directory of not-for-profit organizations and volunteering resources, a newsletter on not-for-profit organization issues, job postings and frequently asked questions.	www.idealist.org
American Society of Association Executives	Provides resources to assist association executives and individuals from for-profit companies that provide products and services to the association community	www.asaenet.org
BBB Wise Giving Alliance	Promotes giving and helps contributors obtain accurate information about charitable organizations	www.give.org
Board Source	Resources to help strengthen not-for-profit organization boards of directors	www.boardsource.org/
The Chronicle of Philanthropy	Articles from the *Chronicle of Philanthropy* newspaper and links to other sites	www.philanthropy.com
CompassPoint Nonprofit Services	Workshops, consulting, publications, and other information and resources of interest to managers of not-for-profit organizations	www.supportcenter.org

Council on Foundations	Includes research, publications, and other information of interest to foundations and corporate donors	www.cof.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpanet.com/
Department of Housing and Urban Development:	Information on programs, resources, and other matters	
Office of Inspector General		www.hud.gov/offices/oig/
Real Estate Assessment Center		www.hud.gov/offices/reac
Financial Accounting Standards Board	Information on the activities of this standard-setting body	www.fasb.org
FedWorld.Gov	U.S. Department of Commerce sponsored site providing access to government publications	www.fedworld.gov
Financial Systems Forum	Topics involving the improvement of financial systems by providing information on methodologies, service organizations, and vendors with a focus on applications concerning accounts payable, accounts receivable, asset management, general ledger, and inventory	www.fsforum.com
The Foundation Center	Information for not-for-profit organizations, donors, and researchers	www.fdncenter.org
Giving USA	American Association of Fund-Raising Counsel sponsored site providing information trends in giving and sources of support	www.aafrc.org
Government Accountability Office	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Guidestar	Information on not-for-profit organizations and news and resources for not-for-profit organizations and donors	www.guidestar.org
Hoovers Online	Online information on various companies and industries	www.hoovers.com

(*continued*)

Independent Sector	A forum to encourage giving, volunteering, not-for-profit initiative, and citizen action	www.independentsector.org
Information for Tax-Exempt Organizations (an IRS site)	A Treasury Department site providing information and answers to frequently asked questions regarding tax-exempt organizations	www.irs.gov/
Management Assistance Program for Nonprofits	Includes the Nonprofit Manager's Library and other resources	www.mapfornonprofits.org
National Association of College and University Business Officers	Provides information geared to colleges and universities, including accounting tutorials on specific situations encountered in higher education accounting	www.nacubo.org
National Committee On Planned Giving	Provides information and resources regarding charitable planned gifts	www.ncpg.org
Pillars of Accountability in the Nonprofit World	Web-based self assessment and planning tool for CEOs and senior managers of nonprofit organizations. Designed for small to mid-size nonprofits.	www.2gather.net/pillars.htm
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing, the activities of the PCAOB, and other matters	www.pcaobus.org
The National Center for Charitable Statistics	Provides statistics on revenue and expenses of not-for-profit organizations	nccs.urban.org
The Nonprofit Genie	Advice, links to other sites, publications, and other information on not-for-profit organization management	www.genie.org
The Nonprofit Resource Center	Information and links to other sites covering financial management, governance, legal, and other matters	www.not-for-profit.org
The Nonprofit Risk Management Center	Provides information to help not-for-profit organizations control their risks	www.nonprofitrisk.org

The Nonprofit Times Online	Articles from the *Nonprofit Times* newspaper and links to other sites	www.nptimes.com
Tax Analysts Online	Provides information on current tax developments	www.tax.org
U.S. Department of Education	Information on programs, resources, and other matters	www.ed.gov
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
U.S. Office of Management and Budget	OMB information and literature	www.whitehouse.gov/OMB/
Vision Project	Information on the profession's Vision Project	www.cpavision.org